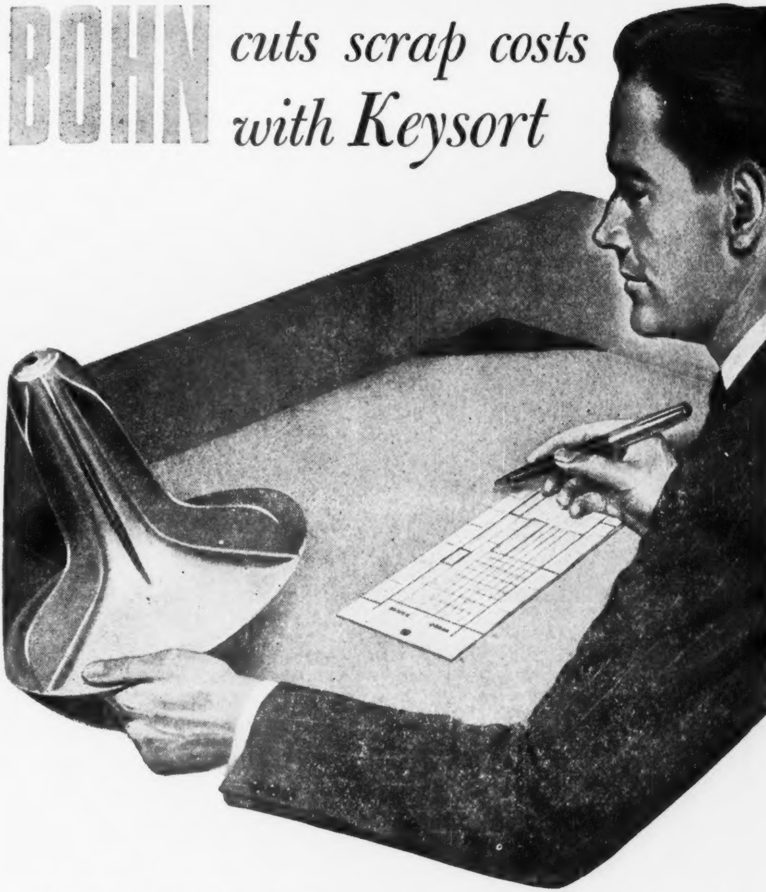
The New York Certified Public Accountant

VOL. XVII — *August · 1947* — No. 8

Published Monthly by
THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
15 E. 41st STREET : NEW YORK 17, N. Y.
Single Copy 35 Cents — One Year $3.50



In a single operation, and in clear, printed figures, these National Payroll Machines prepare checks showing the gross pay, the specific deductions, and the net pay; also, payroll summary and employees' earning record. Labor cost analyses can also be made.

E. R. SQUIBB & SONS

find speed... flexibility... and convenience

...with their National Payroll Machines in preparing their payrolls for some 5,000 employees. This world-famous pharmaceutical house reports:

"Our operators have attained a posting speed that averages 120 per hour, which is rather exceptional for the posting of payroll, considering the number of calculations involved in payrolls, today.

"The flexibility of the machines allows us to supply our employees with pertinent data that most individuals are vitally interested in... the posting of an employee's earnings to date, his withholding tax to date, and his F. I. C. to date.... This allows the employee to know his exact status with the Government each week upon receipt of his pay.

"Our operators say that they like the convenience of the keys and the ease of working the National Payroll Machine. No standing up to replace each individual record, nor unnecessary reaching or stretching." The National Cash Register Company, Dayton 9, Ohio. Offices in principal cities.

National
CASH REGISTERS • ADDING MACHINES
ACCOUNTING MACHINES

THE NATIONAL CASH REGISTER COMPANY

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

VOL. XVII · *August · 1947* · NO. 8

Accounting Control of Retail Inventories

By RICHARD METH, C.P.A.

THE principal asset of a retail business is its inventory of merchandise. In this asset the business has invested most of its capital, and from the sale of this asset it will derive all of its profit. In the corner grocery store or in the national chain store organization the inventory is the chief problem of management; and it requires more supervision than any other asset.

The need to control retail inventories is not a discovery made by the accounting profession. It springs from the owner's instinct to prevent thefts by customers and employees; to protect his property against loss by fire and related hazards which may be avoided by insurance; and to minimize shrinkage in value due to physical deterioration and obsolescence. In larger companies the need for protection is further emphasized by the wide dispersal of inventory and by management's remote control thereof through store managers or other employees. When sales are made for cash, the temptation to be dishonest is heightened.

By professsional training and experience the accountant is a valuable aid to the retailer in achieving these objectives. With an adequate system of inventory control, the accountant can ascertain the value of the inventory without taking physical counts and is thus able to prepare interim accounting reports. He can determine the amount of insurance coverage required and detect shortages resulting from theft and other causes. He can provide information vital to the establishment of efficient merchandising policies.

For the modern business, five methods of control of retail inventory are available to the accountant:

1. Internal store organization
2. Audit by public accountant
3. Maintained gross profit percentage
4. Retail price control
5. Unit control

The five methods cannot be applied to every retail enterprise. Selection of the most appropriate technique depends

RICHARD METH received his certificate as a C.P.A. from the state of New York in 1927 and has been a member of our Society since 1928. He is a member of the Committee on Retail Accounting.

Mr. Meth is Treasurer and Controller of A. S. Beck Shoe Corporation and each of its subsidiaries. He has served as a member of the Shoe Manufacturers Industry Advisory Committee of the War Production Board and holds memberships in a number of trade and manufacturing associations.

This paper was presented at a technical meeting held on May 7, 1947, under the auspices of the Society's Committee on Retail Accounting.

upon the type of retail business, the kinds of products sold, and the valuation methods employed in preparing income tax returns. Since each of these considerations will exert some influence upon the types of control to be adopted, it would be well to discuss them briefly before describing the methods in detail.

Types of Retail Business

The principal kinds of retail business, listed in the order of increasing complexity of organization, are as follows:

1. Independent store
2. Mail order house
3. Department store
4. Chain stores

Each of these types of retail business presents variations in organizational structure, type of personnel employed, method of conducting business, and physical housing and distribution of inventories.

The independent retailer, because of his close personal supervision of all store operations, can provide the benefits of internal store organization. He can observe most of the transactions as they occur as well as the movement of all merchandise in and out of the store. He may be willing to install a simple accounting system from which maintained gross profits can be established, and consent to periodic audits; but don't ask him to install inventory controls by retail price or by units. Such elaborate accounting systems require trained personnel not usually available, and entail costs which may be disproportionate to the amount of business transacted. In larger retail stores enjoying annual sales in excess of $500,000, this shortcoming is not as pronounced. The greatest difficulties, however, will be faced in the small store which is managed by an employee instead of by the owner. In such situations the accountant is usually deprived of an adequate accounting system and the watchful eye of the owner.

Because of the nature of their business, mail order houses, department stores, and chain stores usually transact a large sales volume, require more complex organization, and substantial investments of capital. These companies maintain large inventories which are under the custody of employees, and are usually widely dispersed. Because of their size they must have adequate accounting systems maintained in a central office by trained personnel. In a well-managed company these conditions will lead to all of the controls mentioned, except possibly control by units. Certain types of commodities, however, also lend themselves to unit control.

Types of Products Sold

The possibility of expanding conventional accounting records to provide perpetual inventories at retail price and by units will be determined largely by considerations like the following:

1. The value of each unit
2. The physical characteristics of each unit
3. The stability of the price level

Where the value of each unit warrants, perpetual inventories may record commodities by retail price classifications and quantities, especially if sold by the unit or pair. Gloves, hosiery, shoes, handbags, and many other commodities may be recorded by type, price lines, and units. Some items of great value encourage the most extensive record keeping. It is possible to keep a separate card for each fur coat without incurring unreasonable bookkeeping costs. On the other hand, nails, because of the small value of each item, would not even justify counting, let alone unit control.

Perishable goods, such as foods, do not lend themselves to unit control, although some form of control by retail value is possible with allowances for spoilage based upon experience. Goods in bulk (coal, piece goods) may be recorded in tons, pounds, yards, etc. but

only if it is customary to indicate these measurements on purchase and sales records. Some grocery chains assemble statistics in units of tons.

If the retail price is unstable, then control by retail price or units is less effective. This happens when a store manager has authority to run sales or mark down merchandise. Such authority is often justified to prevent spoilage, or to limit losses from obsolescence due to style changes, etc., which cannot be effectively controlled from the main office. It is also justified when market prices fluctuate rapidly and frequent price changes are necessary. The situations described in this paragraph are illustrated by the sale of fruits in a chain grocery store; by the sale of wearing apparel where style is emphasized; or where seasonal demand for any article may provide a short selling period.

Methods of Valuation Used on Income Tax Returns

Most retailers evaluate their inventories on the basis of cost or market, whichever is lower. Since such values may be determined by physical count at the end of the fiscal year, they are under no further compulsion, because of tax considerations, to augment their records by any of the methods discussed herein.

On the other hand, retailers who have received permission to use the retail method of inventory valuation must keep perpetual inventories at retail price, analyzed by appropriate classifications, and show the amount of mark-on existing in each classification. Such mark-on is used to reduce the retail price to average cost. By adopting this method, inventories at average cost are always available without physical count and monthly operating statements can readily be prepared.

The Internal Revenue Code, in permitting the use of the LIFO method of inventory valuation, contemplated the use of units in determining the extent to which costs may be applied for the various types of merchandise. Some retailers have sought to avoid the enormous difficulties entailed in identifying thousands of specific items and quantities by the use of the retail method in conjunction with an index of price levels. Based upon the recent *Hutzler Brothers Co.* decision, it would appear that the retail method is acceptable for determining costs under LIFO, but the type of national index for price level adjustments used by many department stores has not been accepted.

Internal Store Organization

We have reviewed very briefly the problems presented by the types of retail organizations, the kinds of product sold, and the methods of valuing inventories for tax purposes. We will now review the various types of inventory control. It is proposed to start with the simplest form of control and to indicate, step by step, where additional controls are feasible.

Before the accountant arrived upon the scene, the alert retailer had already solved some of the problems of internal control. Impelled by the need to protect his investment, the retailer learned by instinct a few of the lessons which the accountant acquired by training and experience. In the smallest type of one-man retail store, operated by the proprietor, an almost perfect system of internal control can be practiced. The owner opens the store each morning and closes it each night. He can survey every corner in one swift glance. He checks in all the merchandise, makes all the sales, wraps the goods, rings up the cash. If he is accurate he can be satisfied that his inventory is intact.

As the store grows in size, he loses the complete control enjoyed before. He must hire salesmen, cashiers, wrappers, floormen, porters, perhaps a bookkeeper and a manager—and rely upon their honesty and diligence. But by proper planning of store personnel and procedures he can develop effective internal control. With intelligent management and division of duties he mini-

mizes thefts by customers and employees. Small valuable articles, or those easily broken, are displayed in glass show cases, to be handled by employees only; while bulky articles are left on open counters or display units. All sales must be recorded on duplicate saleschecks; all saleschecks must be numbered; and all numbers accounted for. Saleschecks are approved for price immediately after completing the sale, or, if price tickets are attached, prices may be checked by the wrapper before delivery. Salesmen are forbidden to wrap merchandise or make change. The salesman deposits the cash and two copies of the saleschecks with the cashier, and delivers the merchandise to the wrapper who is usually stationed next to the cashier. The latter passes the duplicate salescheck to the wrapper, who then compares it with the merchandise being wrapped. The customer gets her change from the cashier and claims her package from the wrapper. If all saleschecks are numbered and accounted for, the cashier cannot pocket the cash by the simple device of destroying the check. All merchandise entering or leaving the store is accurately recorded.

The accountant who first perfects the system of internal control inside the store has overcome many of the dangers which beset the retailer.

Audit by Public Accountant

After the store organization is perfected, the retailer turns to the public accountant to install a system of accounting which will record the significant transactions of his business in such manner that an expert may be able, by audit, to verify their accuracy and chart the progress being made. It is not intended here to describe the conduct of an audit, since that is a detailed study by itself, but merely by reference to indicate that an audit is another step in the control of inventories.

Accounting Control by Gross Profit Percentage

Maintained gross profits of the business for prior periods, or for similar businesses operated by others, provide a yardstick for measuring the substantial accuracy of the retail inventory. Standard accounting procedures will yield such comparisons without the detailed records required to assemble perpetual inventories showing retail values or units on hand. Past performances furnish a pattern of gross profits. With some investigation the accountant may detect variations in selling policies, mark-downs, allowances, etc., during the year under review which will reconcile the gross profit realized for the the year with the results recorded for prior years or by related businesses.

One retail department may operate at a much higher mark-up than another —perhaps because the selling costs are higher. If the sales volume in that department is a greater or smaller percentage of the total than in the standard used for comparison, then fluctuations may occur in the combined gross profits. In such cases separate departmental results are necessary. Inventories must be accurately summarized by departments. Sales must be classified by departments. Sometimes a separate cash drawer or register is used for each department, providing an automatic allocation of sales; or, when one cash register is used, certain models will provide the allocation by depressing the appropriate key, such as "restaurant", "liquors", etc. If these devices are not available then sales checks must be assorted by departments at the end of each day. Similarly, purchases must be classified by departments. The simplest arrangement is the columnar purchase book with a separate column for each department. In the larger retail organizations this work can be done with punch card machinery. If other elements of the gross profit are shown, such as allowances, then they, too, must be classified by departments. When these steps have been taken, then main-

tained gross profits and percentages are obtainable for each department, and the results compared separately by departments, just as though each department were a separate business. The best results are usually obtained by comparisons with prior years of the same business. Significant variations should be investigated. Analysis may disclose that they were due to poor initial mark-ons or later mark-downs caused by severe competition, price wars, consumer resistance, sales, etc. Wholesale price levels at inventory times may affect inventory valuations favorably or adversely. The accountant at this point has an opportunity to supply valuable information because management, while aware of the existence of the conditions disclosed, does not often appreciate the true extent of their influence on mark-ups and profits. When acceptable explanations of reduced gross profits are not discovered, the accountant must consider the possible existence of shortages in inventory resulting from thefts by customers or employees, or defalcations due to padding the purchases with fictitious invoices, failure to report and deposit all sales made, and other fraudulent practices. He should not relax his vigilance until satisfactory explanations are made, or appropriate remedial measures are taken.

The progressive proprietor would like to compare the performance of his business with that of competitors or with related retail operations. In the day-by-day struggle for the consumer's dollar, they are always matching wits and revising merchandising policies, such as the type of merchandise carried, price levels, use of brand names, sources of supply, mark-ups and mark-downs, sales promotions, etc. The final test of the success or failure of these policies is often found in the gross profit.

Some industries publish the results of operations as a co-operative effort. Department stores, for example, publish statistics on a nationwide basis showing a fairly complete operating statement with vital percentages of initial mark-ons, mark-downs, shortages, discounts, etc. These results are even analyzed by size groupings according to annual retail sales, and also by departments. Dun and Bradstreet publishes interesting retail statistics from time to time, as does the Harvard Graduate School of Business Administration. While results of individual companies are rarely disclosed in these studies, they nevertheless provide excellent standards against which each retailer may test his own efficiency.

Accounting Control by Retail Price

Thus far, no type of retail inventory control described has demanded any important extension of the conventional accounting records and procedures. Nor has any type provided an absolute proof of shortage or other irregularity. Such proof, however, is provided when perpetual inventories are kept at retail price. This system may not be practical for all retailers. It requires a good deal of clerical work and supervision, but usually works well in the large specialty stores, department stores, and chain stores.

The key to the system is to record all transactions at retail price as well as at cost, and to provide a perpetual inventory at retail price. In this manner the inventory responsibility of the custodian is definitely established.

An additional advantage of installing such a system is that it provides a method for computing frequent inventories at cost as well as at retail, thus eliminating the necessity of taking physical inventories for interim reports. By assembling information to disclose the percentage of mark-on in the retail price, the average cost may be determined.

If merchandise is valued for tax purposes at the lower of cost or market, then in the final inventory the individual items must be priced on that basis; but the retail system may still be used to assemble interim inventories at cost

without physical count. If the retail inventory method has been approved for tax purposes, then physical inventories may be taken at retail only, and the cost is determined by deducting the average mark-on percentage. It is not within the scope of this paper to describe in detail the technical features involved in deriving cost by the retail method.

In the following paragraphs transactions frequently experienced in the retail business are described and the accounting procedures are set forth to provide a perpetual inventory at retail price:

Inventories. Opening and closing inventories must show unit prices and extensions at retail, and at cost as well, if desired.

Purchases. When purchases are made, retail prices are determined and marked on the invoice, which is then extended to show the retail value of the goods bought, as well as their cost. These invoices are entered in the purchase book under appropriate columns to show the retail price (or inventory) and the cost (or accounts payable). Purchase discounts represent additional mark-up, but it is customary to show such income in a separate account.

Sales. Sales are usually recorded at the retail price at which the articles are sold. But if sales are not credited out of inventory at the same price as charged in, then shortages or overages develop. Such situations are reviewed in the following paragraphs, with suggested procedures for avoiding the differences which would otherwise result.

Taxes collected from consumers. Sales, excise, and other taxes imposed upon consumers should be reported separately since they are liabilities and not income. Failure to segregate them would mean that the liability for such taxes would not be disclosed by the books, that sales were erroneously inflated, and that perpetual inventories were improperly reduced.

Mark-ups and mark-downs. Subsequent increases in selling price (mark-ups) must be reported to the accounting office and have the effect of increasing the inventory at retail. Reductions in selling price (mark-downs) have the opposite effect upon the accounting records.

Transfers. Transfers from one department, store, or warehouse to another are recorded at retail price. While they do not affect the total inventory to be accounted for, they do charge and credit the custodians responsible therefor.

Allowances. Allowances in selling price are usually effected by mark-downs; but when this is not so, care should be taken so that, for each sale, the retail inventory is reduced by the original amount at which the article was carried in the inventory, and not by the smaller amount received from the sale. The difference is a charge against gross profit. If three pairs of \$.35 men's hose are offered for \$1.00, the inventory at retail must be credited for \$1.05. This is accomplished by recording the sale (which is credited to retail inventory) at \$1.05; and deducting the allowance of \$.05 as a charge against gross profit. Similar treatment is appropriate for employee discounts and allowances for damaged merchandise. However, allowances made to department store buyers or store managers for shortages arising from thefts, mistakes, or other causes, are in the nature of a reserve against the retail inventory shown by the books.

Credit checks, gift checks, and deposits. Retail policies vary regarding returns of merchandise sold. While some retailers advertise money-back guarantees, others will offer the customer a credit check instead of cash. The gift check is the brain-child of the sales promotion department. Where the donor cannot complete the purchase, she is encouraged to buy a gift check and let the donee make the choice. Deposits are used by some retailers

where a sale cannot otherwise be consummated. If credit is not permitted, some stores will take a deposit and hold the article for a stated period of time until the customer is able to pay the balance; or where the article is not in stock, the store will procure it if the customer will leave a deposit. In all three transactions the accountant observes (a) that the sale has *not* been made, and (b) that the amount received is merely a liability to be discharged by the completion of the sale or a return of the money; and the records should therefore indicate these facts. Where circumstances warrant, some retailers prefer to record the sale when the deposit is made and to show the balance to be paid as an account receivable.

Layaways and will calls. The account will interpret these transactions as the facts dictate. If the sale has been completed and recorded (as is customary in department stores), and delivery is being delayed until payment is completed or to suit the customer's convenience, then no record keeping is required, except such as will establish that the merchandise does not belong to the retailer and should be excluded from his inventory. If the sale has not been completed, the article should be included in inventory.

Analysis of accounts. The accounts described in the foregoing paragraphs may be classified to meet all requirements. Appropriate subdivisions of these accounts in subsidiary records by location of the asset would be necessary by departments, stores, warehouses, etc. to show where the inventory is, and who is responsible for it. Further subdivisions by merchandise categories will give more accurate operating information for the different lines carried. This latter analysis is most important in distinguishing profitable lines from those which are unprofitable.

Summary of retail inventory. The perpetual inventory at retail price may now be computed from the books (as frequently as the accounts are posted) by adding the opening inventory, net purchases, and mark-up adjustments, and by subtracting the net sales and mark-down adjustments. Allowances for shortages may be deducted as a reserve. Any further shortages not thus provided for are either additional losses to be sustained, or sums to be recovered from custodians of the inventory by payment in cash, deduction from security deposits, or collection from bonding companies.

Mark-on percentages available may be applied to the retail inventory to reduce it to average cost. If the retail price of merchandise is marked down immediately by the full amount of its depreciation in value, a procedure generally followed by department stores, the accounts will automatically show the market value of the inventory. For other retailers this is not always realistic, so further reserves from cost to market should be provided.

Control by Units

The control of inventories by retail prices represents a long step forward in the protection of the inventory against theft and other losses, and in furnishing management with clear operating statistics against which to gauge the effectiveness of its merchandising policies. Yet many retailers feel that both of these achievements are limited because they confine their results to categories rather than to specific items. They do not show exactly where the profits were made or where the shortages occurred. Assume that the hosiery department did a good job—overall. Mark-ups were good and inventories were not excessive. But that may be true of nylons only. Perhaps the opposite was true of silk or rayon hosiery. And as to the nylons—at what retail prices did the sales volume increase? At $1.49? Where did consumer resistance develop? At $2.29? Answers to these questions result in cancellations or reorders, in mark-downs or close-outs, in increase or decrease in the stock on hand.

One method of supplying such information is by frequent inventories submitted by the manager. Where sizes, widths or other measurements are factors, certainly on-the-spot inventories are necessary, perhaps once each week, or even more often when style selling is intensified during short seasons.

Another method is to install unit control as an integral part of the accounting system. Such a system, as previously explained, does not work for all retailers. But it is effective for radios, for automobiles, for clothing, shoes, and accessories—wherever the unit is of convenient size, accessibility, and value. Unit control is most effective when used in conjunction with control by retail price; but it can also be used in cases where no retail price control has been established. To be concrete, let us assume that one of the departments controlled by retail price is the hosiery department. We now wish to add unit control for hosiery. The same steps outlined for control by retail price must be followed through to get adequate data by units.

Some chain stores require a daily report to be submitted which combines the functions of a perpetual inventory by units and a sales report. Such reports may also cover a week, or any other convenient period. Under appropriate vertical columns they control the entire store inventory. There may be eight price lines for hosiery. These may be grouped together in the hosiery section with eight columns, one for each retail price, which is shown at the top. Other lines may be carried in the store—handbags, gloves, shoes, slippers, rubbers—which would be recorded like the hosiery. It is possible to operate such a report for as many as fifty or one hundred columns (or commodities by retail price); but columns in excess of that number may require an unwieldy report with excessive clerical costs. Separate forms are printed for each type of transaction, and every entry on the report must be supported by the appropriate document (salescheck, gift check, etc.) which accompanies the report.

The horizontal lines record the same type of information described for control by retail price. In effect, the latter is the control account and each column of the daily report is a subsidiary account. If the opening inventory of hosiery consisted of three price lines for men's hose and five for women's, each of these eight price lines would be assigned a column headed by its retail price. The first line would require the opening inventory by units. After the eight entries are made, the daily report shows an inventory of hosiery by units equal at retail to the retail value of the physical inventory.

Direct purchases are distributed in the same way, by posting the units bought to the appropriate section under the proper retail price. The next line shows transfers in from the warehouse or another store, and the debits are complete. At this point a sub-total is entered for each column.

Saleschecks are sorted by categories and price lines and then posted in the credit section of the daily report. The manager is required to deposit as sales the money equivalent of all the units credited out of inventory by entry on this line. Sales taxes collected are shown as additional receipts in the cash summary, to be credited to the appropriate liability account. The mere entry of the units records the sale at the full price. Where allowances have been made, they are claimed as a deduction in the cash summary, and proper supporting data appears on the accompanying salescheck. Merchandise sent to other stores or returned to the warehouse may be recorded on the next line as "transfers out". Mark-ups and mark-downs are recorded by the simple device of transferring the number of units marked up or marked down from one price column to another. If 500 pairs of hose are reduced from \$1.79 to \$1.59, that quantity is "transferred out" in the \$1.79 column and

"transferred in" in the $1.59 column. A sub-total of the credits is then recorded, which is subtracted from the sub-total of debits. The remainder is the closing balance to be brought forward as the opening inventory on the next report, and that completes the perpetual inventory for the period covered.

The other transactions familiar to the retailer do not involve the perpetual inventory, although some may involve cash and require entry in the cash summary. Since credit checks, gift checks, and deposits are usually not sales, but liabilities, the cash received from them is entered as such in the cash summary and supported by duplicate copies of these documents attached to the report. When the sale does occur a sales check is prepared, and in lieu of payment in cash the customer surrenders the original credit checks, etc. Instead of debiting cash on his cash summary, the manager debits the liability account, attaching the original documents surrendered by the customer as the equivalent of cash. Layaways and will calls which are not sales do not require entry on the report; they refer merely to the segregation of the physical inventory.

Not only is unit control an effective tool for carrying out merchandising policies, but it also reduces discrepancies in inventories. Shortages and overages are localized by specific items and can be more easily prevented. By preparing his own reports and retaining a carbon copy for himself, the store manager determines his own perpetual inventories and readily acknowledges the extent of his responsibility. He is able to check his inventories quickly by price lines and units, and by frequent verification keep shortages to a minimum. A perpetual inventory by units reduces shortages, facilitates the bonding of store managers, and keeps insurance premium costs at a minimum.

Supplemental Controls

As stated in the previous paragraph, the perpetual inventory in units gives the store manager a convenient instrument for taking a quick inventory. He can take the count as often as he thinks necessary to detect and isolate thefts or shortages in the early stages.

Most companies which own inventories entrusted to others employ stock auditors to visit the stores and warehouses for periodic counts. As an added precaution, these custodians may be bonded with an insurance company that will undertake to pay all shortages discovered. Bonding companies usually issue policies only where a good accounting system is available to establish accurately the amount of any shortages, and where internal stock auditors make counts at least every two months or within such other period as is agreed upon.

Guides to Merchandising Policies

Every retail establishment derives its profits principally from the sale of the inventory, and the size of the profit is influenced more by the policies of the merchandising division than by any other factor in the business. The accountant who does not grasp this vital fact will have a loose contact with reality, and diminish his usefulness to the client. Every merchandising aid which the accountant can render is a legitimate discharge of his obligation to control the inventory.

Some lines of business, notably wearing apparel, are sharply affected by weather. A heavy rainfall (especially on a good shopping day like Saturday) will depress sales of most items but increase sales of umbrellas and raincoats; or a snowstorm will decrease shoe sales but increase rubber sales. Premature cold or heat will upset sales budgets of seasonal articles because buyers may not have provided adequate stocks. It is simple for each sales report to show the weather for the day.

An accounting system that provides periodic inventories by departments, by categories, by price lines, by styles, or by units supplies to the merchandising personnel concrete information from

which they can determine the condition of the inventory. Buying programs may be adjusted to prevent overstocking; timely sales may be offered which will prevent severe obsolescence at a later date; and other remedial action taken.

Where selling branches are operated in several communities, good records may enable the merchandise division to transfer styles or sizes from one location which has the inventory but not the sales, to another which has the sales but not the inventory. Highly styled or seasonal articles usually have a short selling period, and such transfers help to increase sales volume and reduce inventory obsolescence.

Companies operating on a budget usually provide an "open-to-buy" position for each department or store. Such records, based upon past experience, sales forecasts, and accepted policies, chart the size of the inventory at different times and warn the buyer when his stock is too high or too low. Intelligent operation of such a program will not only keep the inventory at reasonable levels and minimize losses due to sales and mark-downs; it will also prevent strains upon the Company's financial structure and credit standing by avoiding unexpected demands for payment of bills.

Mark-up information of the kind previously described is most important in formulating merchandising plans. It can measure the performance of each store or department so that unprofitable locations may be closed and profitable ones maintained, at the same time exposing the circumstances that brought about each result. Poor results in certain lines throw a spotlight on the buyer's failures which developed consumer resistance, while good results in other lines reveal sound policies which may be continued or expanded. An analysis of the gross profit, from the initial mark-on down to the final gross profit realized, will measure the effects of selling and merchandising programs, so that an informed management can operate the business successfully.

Special Problems in Connection with Chain Store Accounting

By Nathan Rodstein, C.P.A. and Robert A. Wiener, C.P.A.

The term chain store connotes a group of two or more retail stores operating under a common ownership and control. For the purposes of this discussion we shall be concerned primarily with those larger chains where a certain amount of absentee control necessarily exists.

The principal problems usually deal with the relationships between employees and management, the flow of merchandise and cash within the organization, and the allocation of main office expenses. Other aspects of chain store problems that we shall discuss are home-office control of layaway merchandise and accounting for layaways. We shall attempt to confine this discussion to features that apply essentially to chain stores but we must point out that many of these problems exist in any business enterprise selling merchandise to the public.

Robert A. Wiener, C.P.A., is a member of the Society and of the American Institute of Accountants. He is a member of the Society's Committee on Retail Accounting and of its Committee on Budgets and Budgetary Control. He is engaged in general practice as a certified public accountant with offices in New York, Little Neck, L. I., and Asbury Park, N. J.

Nathan Rodstein, C.P.A., is a member of the Society and of the American Institute of Accountants. He is also a member of the Society's Committee on Retail Accounting. He is on the staff of David Berdon and Co., C.P.A.'s, New York, N. Y.

This paper was presented at a technical meeting held on May 7, 1947, under the auspices of the Society's Committee on Retail Accounting.

Merchandise

It is not necessary for us to discuss the retail method of inventory control as our colleague has already covered this subject adequately. We shall, however, make a few remarks that we feel are pertinent.

The ready-to-wear chains have found it expedient to locate their home offices close to their sources of supply to take advantage of consequent low delivery costs. This also permits the buyers to survey the market frequently and thus to gain an awareness of the latest in style creation.

When chain stores place orders with manufacturers, they stipulate either delivery to the home office for distribution to the stores or direct shipments (drop shipments) to particular stores. The control, receipt and distribution of the merchandise under each of these plans of purchase will now be discussed.

Shipments to the Home Office

Merchandise must be checked in, entered on inventory records, and allocated to the various units. As you know, under the retail inventory system, which is in vogue in many retail chain stores, merchandise purchased is entered at both cost and selling price.

Costing of Inventories and Shipments to Stores

It is important not only for credit and closing statements but for interim reports as well, to evaluate inventories and store shipments properly so that the cost of sales at individual stores may be computed as accurately as possible. This is usually accomplished by applying to the retail value of the shipments to stores and to the retail value of the closing inventories, a percentage which will yield what purports to be the average cost of the merchandise available for sale at the store. The

percentage to be used usually is arrived at by one of three methods.

Under the first method the percentage is arrived at by using as a numerator the cost of the merchandise purchased during the current fiscal period and as a denominator the retail price of such purchases.

The second method calls for a percentage obtained by using as a numerator the average cost of the opening inventory (arrived at by using the retail inventory method) plus the cost of the merchandise purchased during the current fiscal period and as a denominator the retail price of the opening inventory plus the purchases at retail.

Under the third method the percentage to be applied to the shipments to stores is determined by using as a numerator the total average cost of the home office inventory and the cost of purchases for a season or for a shorter period, and as a denominator the retail price of this merchandise. A second percentage is obtained by using as a numerator the average cost of the opening inventory at the stores and the shipments to stores for the same period, and as a denominator the retail value of this merchandise. The second percentage is applied to the closing store inventories at retail.

It is apparent that the procedure under the third method as outlined above will give more accurate results because the percentages thus obtained are based upon data which is more current than that used under the other two methods. We, therefore, recommend the third method for chain store use. However, where the percentage of mark-on remains fairly constant, either of the first two methods may be availed of with satisfactory results.

All costing, of course, should be done on a departmental rather than on a store basis.

Inventories computed in the aforestated manner are predicated on Fifo (first in, first out) basis. It is possible, however, to use Lifo (last in, first out) method in conjunction with the retail inventory method. This requires the use of authentic retail price indexes showing fluctuations in retail prices between specific dates.

Control of Inventories

Inventories are controlled by two methods, or a combination of both: unit control and/or dollar control. The best method, although the costliest to maintain both in amount of detail and personnel required, is the unit control. This attempts to set up, by style and price line, the quantity of merchandise and its location. The amount of detail necessary under this system puts a premium on efficiency and accuracy since personnel may easily make costly mistakes. The retail inventory system will give us the dollar value of merchandise on hand by departments at any given date in each store.

Control of Shipments to Stores by Home Office

Merchandise is allocated to the stores by the home office. Before shipment is made, the merchandise must be checked for salability and then allocated so that quantities are correctly set aside. One copy of the shipping ticket accompanies the shipment. A second copy is mailed to the store manager and a third is retained at the office. All forms should be prenumbered. When the merchandise is received at the store, the manager signs the copy enclosed and mails it back to the home office where it is matched with the office copy. It is a simple matter for the home office to control shipments when the managers account for merchandise received. If a triplicate copy remains unmatched for a certain length of time, the home office sends out a tracer to see what has happened to the merchandise. All matched tickets constitute the store shipments for the period, and all unmatched tickets are considered either part of the home office inventory or merchandise in transit.

Control of Drop Shipments

Certain merchandise does not have to be checked and shipped by the home

office. Such merchandise is sent directly to the stores by the manufacturer. The store manager confirms receipt of the shipment by returning the signed copy of the shipping receipt, thereby providing the authority required at the home office for the payment of the vendors' bills.

Control of Markdowns

Stores are charged for all merchandise received at selling price. The home office expects to receive all cash collected at the store. Since unscrupulous store managers would be able to appropriate cash by merchandise markdowns, the store manager should not have a free hand in marking down merchandise. Moreover price policy should be established by the home office, which should authorize and control markdowns. The unit control records should be checked to see that the quantities agree with the amount reported by the store manager on a sales markdown.

It is customary in retail businesses to permit employees to purchase items for personal use at a reduced price. The markdown should be signed by the employee involved, approved by the store manager and sent to the home office.

Each store manager should have a prenumbered markdown pad, and home office personnel should check to see that all numbers are accounted for. If this is carried out, shortages between book and physical inventories should be greatly curtailed.

Markdowns on Merchandise Transferred

Where merchandise has been at one location for any length of time, it usually becomes shopworn and soiled. Such merchandise is usually disposed of in store units especially equipped to dispose of distress stock. Obviously such goods cannot be sold at full retail price, and since it would be unfair to charge the selling store with the loss involved in the sale of these goods the markdown should be taken by the transferring store.

Occasionally we find that the home office will recall merchandise that is not moving. It is inspected when it is received and if found to be in good condition will either be sent to another store, or if it is seasonal merchandise it will be stored away until the following season. Any markdown taken on this merchandise should be allocated to all the stores in the chain.

Layaways

Layaway merchandise is always a problem in chain stores. It is customary for stores to have merchandise on hand which may be the customer's property or merely segregated for the customer's convenience, depending on the terms of the sales contract. The layaway garment is put on a separate rack until the customer pays the balance and claims the garment. A separate prenumbered sales book for layaways (containing all conditions of the sale) should be maintained at each store. The sales slip should be made out in triplicate; one copy going to the customer, one to the home office and one attached to the garment.

There are two methods of accounting for layaways depending on when title to the merchandise passes. Under one method, the sale takes place at the time the customer leaves the deposit. The sale is recorded on the sales report at that time, and an account receivable is set up for the balance due. The general ledger account is the controlling account, and the copies of the layaway tickets are used as the subsidiary schedule of accounts receivable.

Under the second method, the sale takes place at the time the merchandise is redeemed. Under this method the layaway slip is merely a memorandum record of the transaction. This is also made out in triplicate. The amount received is entered as a deposit payable or due bill payable and duplicates of such due bills payable constitute the underlying accounts which are controlled by the general ledger controlling account.

In order that layaway garments

should not remain on the racks for too long a time, the home office must check the layaway tickets frequently to see what disposition has been made of the merchandise.

Cash Report and Control of Cash

Cash is the most fluid of mercantile assets. For this reason it may flow in directions other than those intended by the proprietors of business.

In view of the fact that the basic controls of chain store operations flow from the home office, local employees are sometimes tempted to indulge in peculations which they are inclined to feel will not be discovered by management. To control the flow of cash many devices have been instituted by management in order to assign responsibility.

One of the cardinal principles of chain store accounting is that all receipts must be banked immediately after the close of business each day. With after-hour depositories maintained by most banks, this is a simple procedure to follow. Duplicate deposit slips countersigned and dated by the bank are forwarded to the home office with the daily report. Some chains have arranged with banks to send the duplicate deposit slip directly to the home office, so that there is no chance of a dishonest store manager or cashier making any alterations on the deposit slip. These bank deposit slips should be compared with the daily sales report. No doubt practicing accountants can recall many cases where these duplicate deposit slips are merely filed away without any checkup made by the home office. It is only when the accountant reconciles the bank statement and finds that the deposits do not agree with the recorded receipts for the day that a detailed check is made.

Store managers usually like to show large volume on weekends because such a performance is expected of them. They hold back their cash and sales, which then appear on later reports. The only way to curtail this practice is to have occasional spot checks of inventory, layaways and cash, made by traveling auditors. The common practice of cut-offs also makes it difficult to check store receipts.

In retail business, there usually are discrepancies between cash register readings and the actual cash on hand. Overages or shortages may result. In most cases store managers are charged with the shortages. On the other hand, overages are expected to be deposited with the cash for the day. There is, however, no way to check this unless traveling auditors are employed. Store managers usually maintain private funds of these overages, and use them to rectify shortages. The daily report, therefore, will not reflect either condition.

It is interesting to note that in a recent audit a store manager had over-deposited $500 because of an error in addition on the daily report, and that he did not discover this condition until three weeks had elapsed. The store involved was not so large that the over-deposit could go unnoticed for any length of time, so that the error was finally picked up by the store manager.

The elaborateness of the combined cash and sales report now commonly used is the result of years of experience in controlling cash and merchandise. In order to maintain checks on employee honesty and also to keep up the extensive inventory controls required at the home office, these detailed reports have been devised. If it is borne in mind that these reports must be filed daily, some idea of the amount of detail required to transcribe the necessary information at the store and to extract it at the home office is obtained. When you consider that such work must be compiled for each unit in a chain, it is evident that one of the biggest chain store problems is concerned with adequate, competent personnel.

Transfer of Store Funds

All bills for purchases of merchandise and store expenses are paid from the home office. The individual store, however, plays a part in this procedure.

Each store has a draft account in a nearby bank in the name of the chain. The store manager is permitted only to make deposits, and he has no authority to make withdrawals. The store accounts are drawn upon by the home office under the signatures of two persons in authority there. Funds are drawn from these unit accounts at regular intervals and deposited in the home office bank. Two methods are in common use. A round sum is withdrawn periodically, or the entire store receipts are withdrawn. Under the second method, the entire store receipts are withdrawn except for a fixed amount previously deposited as an imprest fund. Where the second method is used it is easier to control the receipts.

Allocation of Home Office Expenses

Expenses incurred at the home office must be charged to the various units. A profit and loss statement prepared for one store in a chain would not show the true picture with respect to the store if all that it contained was a net profit from store operations, determined by taking the gross profit on sales of merchandise less store expenses. The administrative expenses of the home office must be charged to each store in order to show a true profit or loss from store operations. This is done either by charging to each store in the chain a fixed percentage of sales as a service charge, or by allocating the actual home office expenses to each store on the basis of sales.

Taxes

Chain stores operating in interstate commerce are subject to the tax laws of each state wherein they are domiciled. With the multiplicity of state tax regulations, it is possible for a chain to be taxed on more than 100% of its profits caused by differences in allocation bases. In order to minimize their tax liabilities, many chain stores have resorted to the practice of organizing domestic corporations of their stores located in a particular area. Where separate corporations are formed state taxes are paid only on actual earnings within the state.

We have tried here, in general terms, to bring to your attention certain special problems relating to chain store accounting. Each problem and its control can be the subject of a lengthy discussion, but it has been our purpose here simply to highlight the items we feel are most important in chain store accounting.

Machine Equipment as an Aid to Retail Accounting

By Harold M. Kaufman, C.P.A.

The well-known retail slogan of a "volume in millions but a profit in pennies" would be non-existent today without the advantages afforded by machine installations. Machines aid us in maintaining profitable operations either by doing the work that previously required many more employees or by providing management with more information quickly enough to be transformed into economies of merchandising efficiency.

Since machine equipment used in accounts payable, general and subsidiary ledgers, preparation of payrolls, and other functions prevalent in all types of business is adequately covered by other committees of the society, I shall limit my discussion to those machines which are pertinent to retail operations.

Harold M. Kaufman, C.P.A., is a member of the Society and of its Committee on Retail Accounting; he is also a member of the American Institute of Accountants.

Prior to World War II, Mr. Kaufman was Assistant Controller of a Washington, D. C. department store. He was also Assistant Controller of a large ladies' shoe concern, with responsibility for its Retail Division.

During World War II he served for 3½ years with the United States Coast Guard in the Caribbean area, attaining the rank of Chief Warrant Officer in the Pay and Supply Division.

He is presently engaged in public practice as a partner in the firm of Jerome G. Futerman & Co.

This paper was presented at a technical meeting held on May 7, 1947, under the auspices of the Society's Committee on Retail Accounting.

Three subjects which fall particularly in this category are sales audit, inventory control and accounts receivable. Since Mr. Meth has covered the subject of inventory control so thoroughly this evening, I shall only touch upon it incidentally and shall concentrate on sales audit and accounts receivable.

It is in the sales audit department that we learn the total sales for the day and, also, whether those sales were made for cash, charge, C.O.D., or any other method we may use. In the store of today, we must also learn the sales of each department and for incentive payroll plans, the sales of each clerk. Naturally, we must also check extensions and additions as well as maintain rigid controls over missing saleschecks. This information is basic and necessary for all stores. But we have other demands made upon our sales audit department for analyses of every type running from the number of sales made in a given department to a complete analysis of sales by commodity and style number.

Obviously, the system must be designed to fit the needs of the organization. We have many to choose from, all of which will be satisfactory under particular conditions.

The simplest, of course, is the "hand" or "manual" system of auditing. However, this is a misnomer, since adding or calculating machines are a necessary part of the method. The procedure consists of assorting and listing the saleschecks in a variety of ways depending upon the results desired. It is sometimes made easier by the use of calculators that retain sub-totals, thereby eliminating the need for separate recapitulation. Various companies have devised forms and methods to assist

the hand auditor. Notable among these is the McBee Company with a wealth of material for preparing and collating summaries.

When the volume of transactions begins to expand, we must look for new methods and equipment. The next step is to find a machine complex enough to give us the required information without the necessity of constantly re-sorting the saleschecks, yet simple enough to permit us to get the job done quickly.

There are two companies that I believe to be outstanding leaders in this field and which have concentrated on installations to do the job. They are the National Cash Register Company and The International Business Machines Corporation. In my opinion, the former is very satisfactory for small and medium size operations, while the latter is practically indispensable for the larger and more complex types of installation.

The National Cash Register Company has developed its Class 2000 machine, so that it will record the required information by means of registers which accumulate twenty-seven different totals. In some operations, additions on a salescheck are verified automatically, totals are accumulated by sales clerk, and an analysis of each salesman's sales insofar as cash, charge, C. O. D., and department in which sold, is made. However, the one drawback to this machine is that in certain operations the totals for each salesman are not retained in the machine and, as a result, the information on the summary sheet prepared for each salesman must be inserted into the machine a second time in order to arrive at the total departmental sales and sales for cash, on account and C.O.D. However, this is a decided improvement over the manual system since the original information is tabulated all in one operation.

This machine also may be adapted to merchandise analysis work by means of non-adding number keys which will print a style number on a ticket that is automatically issued from the machine. These tickets must then be sorted manually and a listing made of the sales by each style number and by groups, as desired by the merchandising department. For an analysis of high unit value items, this procedure is quite efficient since it is actually a by-product of the sales audit operation. However, when the quantities are increased, its merit is proportionately decreased.

This machine can also be adapted to record units of sales so that unit controls may be kept where desired. Where, in certain departments, the units are substantially the same, such as hosiery, and the unit inventory is maintained only of total pairs, the information may be obtained from the machine totals themselves. However, where complete unit controls are maintained by commodities, the information will have to be obtained by sorting the tickets issued from the machine. The machine is simple and easy to operate and clerks can be trained without previous experience. The combination of twenty-seven accumulating registers plus a battery of ten rows of adding keys combined with the receipts issued from the machine make it adaptable to many types of analyses.

I.B.M. has the more flexible operation by means of punched cards which are designed to give all of the information necessary and with only slight variations provide any other facts that are desired. The information appearing on a salescheck is reproduced by means of holes punched into a rectangular card. When all the cards have been punched, they are put through a sorting machine to be arranged in the desired order and then tabulated on the accounting machine. Summary cards are punched automatically so that various other analyses may be obtained without the necessity of putting all the original cards through the machines again.

In this set-up, missing saleschecks

are easily identified by means of an "M" automatically listed when a number is skipped. The one card prepared from the salescheck becomes the basic record and serves three accounting functions. It is used for sales audit, accounts receivable and merchandise control, and it assures management that all accounting records will be in agreement with all established controls.

The punching procedure follows the usual routine of the audit office and would normally occur after the verification of the salescheck. Some of the information may be punched automatically by the duplicating feature of the key punch. Date, department number, sales person number, and salesbook number are a few of the items that may be treated in this manner. Where cash registers are used, the cash sales for each clerk must be recorded from a daily report of the register reading after being tallied by the cashier.

In the auditing office, a daily report of sales is prepared and summary cards are automatically prepared for each sales person so that weekly and monthly reports of sales may be available for the calculation of commissions.

The varied uses to which these machines may be adapted are unlimited and will provide many types of analyses, tabluations or controls. The basic installation usually consists of two key-punch machines, one horizontal sorter and one tabulating machine. Personnel to operate this equipment may be trained without too much difficulty. The key punch operators require a good deal of experience before they pick up speed and a competent person is usually required to adjust the wiring boards for the tabulating machine.

In a small operation, there is usually very slight, if any, saving of personnel and the added burden of approximately $500 per month. However, as we get away from a minimum installation, the increased I.B.M. cost is slight, with a greater saving of personnel. Those companies who wish to avail themselves of the advantages of the I.B.M. system, but who do not wish to assume a full installation may participate by sending the work out to companies who specialize in doing work on a piece work basis. There is a program available where all the saleschecks are sent out and the completed summaries returned, or the cards punched on the premises and only sorted and tabulated outside. This method has proven highly effective since the work is usually done at night and weekends, thereby permitting the retailer full use of the information during the working day.

Whenever there is a great demand for merchandising information, the great flexibility of the I.B.M. machine lends itself to commodity analysis in any form desired.

The most widespread use of machines in retail accounting seems to be in accounts receivable. The great volume of similar transactions lends itself to use of automatic equipment. Here again, the retail operation is unique and requires that special attention be directed to it for several reasons. First, the great number of accounts and the volume of transactions per month and second the need for maintaining up-to-the-minute credit records for speedy authorization.

Several of the machine companies are advocating a system which is a combination of that used by the utilities and the banks and which they call "cycle billing". It is not too important which installation is used, whether Burroughs, Remington Rand, National Cash Register or International Business Machines, although for a particular system one may be more advantageous than the other. The basic principle is to divide the month into several mailing dates and to arrange to send out a proportionate number of bills on each day, so that each customer will receive a bill on the same day each month, though not necessarily on the first.

The usual procedure in a cycle billing system is to accumulate the saleschecks and cash payment posting media

in a central file which is also used for credit purposes. These files are arranged in controls by cycle dates which vary from five to twenty, depending upon the size of the company. However, in large installations, each cycle date may have one or more control groups within it.

The work of assorting charge tickets into the cycle controls is performed immediately after the sales audit department finishes its work. The totals of the control cycles are then compared with the total charge sales for the day. When all control entries have been made, the posting media are ready to be stuffed into the respective files.

At the arrival of the billing date, the complete file is removed and transferred to the billing department. Here, the machine companies offer either descriptive of skeletonized billing, depending upon individual choice.

The next step is the filming of both the bills and the posting media. This to me is one of the most important advantages of the system. The film record can be filed in less than one per cent of the space required for duplicate bills and saleschecks. Those of us who have had the experience of scavenging for accessible filing space will appreciate this feature.

Naturally, conversion to a system of this type is quite a complex matter and offers many stumbling blocks to a successful installation. However, the advantages in a cycle billing system should not be overlooked and in my opinion offer sound reasons for converting regardless of the troublesome transition period.

First, it offers a sound method of eliminating the peaks in the accounting department when bills "must go out" and all other current work lags behind.

Second, it makes your personnel more flexible since there is always work to fill in on, such as billing, photographing, mailing and stuffing, which operations are going on continuously.

Third, the photographing of saleschecks and statements reduces the filing space required down to an insignificant amount.

Fourth, the mailing of bills periodically throughout the month brings money into the store every day and eliminates heavy cash posting at the beginning of the month.

Fifth, and to me most important, is the advantage to the merchandising department which accrues from having selective groups of customers to whom mail may be sent at any day throughout the month. A wide-awake advertising department may take advantage of this opportunity to reach a limited number of prospective purchasers where a desirable item is in short supply.

I believe that cycle billing offers the best means of cooperation between the accounting and merchandising departments and we must admit that if we do not assist the merchandising departments to make sales, we have no justification for an accounting department.

Before concluding, I want to take a moment to make reference to a new principle introduced to machine accounting by I.B.M. It is called "mark sensing". It is the electronic interpretation of marks recorded by hand. By this procedure, a hand recorded card may be inserted into a machine and the results tabulated without the services of a key punch operator.

Its ramifications are unlimited and I can immediately see wide use for it in inventory control, payroll, merchandise analysis and sales distribution. For example, in taking a physical inventory, the code number, quantity and price may be recorded by marks, inserted in the proper columns and from that point forward, the entire operation of sorting and pricing is automatically provided by the machine.

In conclusion, let me offer a word of warning that machine installations will not necessarily mean a saving of personnel, but will usually permit you to make your time and money more productive by providing management with more and better reports when they will do the most good.

Tax Accounting for Retail Chain Stores

By MAURICE H. RICH, C.P.A.

I. Introduction

In the case of retail chain stores, there are a great many accounts which are similar to those found in other industries and there is no particular reason to go through all of the accounts that you would find. In order to use my limited time most efficiently I have selected a few accounts that have been noteworthy for special tax treatment, in my experience.

The first is inventories. In retail chain stores, inventories sometimes comprise from one-third to one-half of the total assets and they constitute the most important account.

The second account which I will discuss is leasehold improvements. Often, this is the next largest, particularly in chains which do not own the real estate used in the business.

And, finally, I will say a few words about particular problems of Section 45 of the Internal Revenue Code which relate to the allocation of income and deductions among related enterprises. These problems arise where a principal company operates the home office and subsidiary corporations operate the stores.

MAURICE H. RICH, C.P.A., is a member of the Society and of its Committee on Federal Taxation. He is also a member of the New York Bar.

Mr. Rich earned his degrees of B.S. in Econ. and M.B.A. at New York University, and the LL.B. at Fordham University.

He was a United States Internal Revenue Agent from 1935 to 1944. He is now practicing as a tax lawyer with a prominent New York firm of attorneys. He is also a lecturer on tax law and accounting at the New York University Graduate School of Business Administration.

This paper was presented by Mr. Rich at a technical meeting conducted by the Society's Committee on Federal Taxation on May 5, 1947, at the Engineering Auditorium.

II. Retail Method for Inventories

As to inventories, I have narrowed the subject to "The Retail Method of Pricing Inventories". The other more usual methods of pricing inventories do not require special comment here.

The authority for the retail method is given in the Internal Revenue Code.[1] As you know, it is a short-cut method to overcome the difficulties of what could be a very formidable problem. In the usual retail store there is a great variety of styles, sizes, colors and types of different items, and the items themselves are constantly changing because of style changes or changes in the seasons. If it were necessary, in taking the inventory, to identify each particular item with a particular invoice to determine its cost, it would be an almost impossible job.

There are three requirements in the law for the use of the retail method.[2] First, its use must be designated on the tax return as it isn't always apparent, whether the retail method has been used. The retail method results in what may appear to be inventories on a cost, or cost-or-market method, with some approximations.

Secondly, you must keep accurate accounts. That may sound like a superfluous instruction, particularly in connection with Internal Revenue matters, but it is listed as one of the requirements and I will mention it further in a few moments.

The third requirement is that it must

[1] Section 22(c) I.R.C.

[2] Section 29.22(c)(8), Reg. 111.

be used consistently once it is adopted. You have the choice to adopt it in the beginning, but thereafter, in order to change, you must get permission of the Commissioner of Internal Revenue, as provided by the Regulations.[3]

As to the procedure, in brief: first, the purchase records must show both the cost and the retail selling price of the items. That is usually easy because you know what your mark-up is, and when the invoices come in they can be priced accordingly.

Second, permanent records must be kept of all the purchases and sales (which you would ordinarily do anyway) but, in addition, you must keep permanent records of mark-downs and other adjustments of retail prices during the period.

Having done all this, the rest of the procedure is comparatively a simple matter. You simply take your closing inventory at retail prices and then, by eliminating the proper percentage of mark-up, you reduce it to what is generally equivalent to cost, or cost-or-market. In order to get the percentage to be used for this purpose, you start with the opening inventory which you already have computed at both cost and at retail selling price. Then you add to each figure the purchases which you have kept on the bases of both cost and retail selling price. In that way, you get two total figures: one for the cost of the opening inventory and cost of purchases, and the other for the retail selling price of the opening inventory and retail price of purchases. By comparing the two, you find the difference between your cost and your retail selling price, and this gives the percentage of mark-on which is to be considered.

Then, coming back to the other figure we derive—the closing inventory at retail selling prices—we eliminate the percentage of mark-on for that period and that brings the closing inventory to cost, or cost-or-market. The effect of it is this:

If you have a constant market or if you have a rising market, you will get the equivalent of cost in your inventory. On the other hand, if you have a declining market, you will get the effect of market prices also, and you will get an approximation of cost-or-market-whichever-is-lower. That is the net effect of using the retail method.

And so, to sum up briefly, the purpose of using the method is to avoid the difficulties of identifying a great many sizes and styles of items against particular invoices, and the effect of it is to reduce the retail selling price of your closing inventory to cost, or cost-or-market, or a reasonable approximation which will be accepted by the Government.

You may find, toward the end of your accounting period, that you desire to set up a reserve for anticipated mark-downs, as a conservative accounting practice. I think you know that the Bureau of Internal Revenue will not recognize it as a deduction from income. It is just like other reserves and other contingencies that we try to provide for under good accounting practice; but the Government says you may not take deductions unless they are paid or incurred and you may not take losses unless they are sustained. So you may have to make an adjustment between your books and the return to that extent.

III. Elective Method: LIFO

Now, in addition to the retail method, it is possible to use the elective method of inventories.[4] The elective method is sometimes referred to as LIFO, for the initials L-I-F-O meaning "Last In, First Out". Now at first impression it may seem that you couldn't use LIFO in connection with the retail method because they proceed from opposite bases. The retail method tries to obtain the result where identification is not possible. On the other hand, the LIFO method may not be used unless you can

[3] Section 29.41-2, Reg. 111.

[4] Section 22(d) I.R.C.

identify, because, under the last in, first out rule, you have to be able to show to what extent your closing inventory includes goods that were in the opening inventory. And so it seemed for some time that the two methods could not be used together, until a case came down in the Tax Court, in January of this year, involving Hutzler Brothers, a department store in Baltimore.[5]

The year involved was 1942 and Hutzler Brothers Department Store had combined the two methods. Upon examination, the Commissioner of Internal Revenue held that it could not be done for the reason that I just stated: that you couldn't have one method based on no identification and another based on actual identification and then put the two together.

The Tax Court didn't go along with that, but enunciated the rule that you don't have to identify with any particularity under the LIFO or elective method.

It may be of interest for you to know what Hutzler Brothers did. They took their closing inventory at retail and then they applied an index number—the Index of Retail Prices for the year 1942, in order to reduce the retail price at the end of the year to what the retail price would be at the beginning of the year on the same merchandise.

Just to illustrate, suppose the Retail Price Index had gone up from 100 to 110 by the end of the year: the inventory at retail would then have been divided by 110% and that would give you the closing inventory at the retail level prevailing at the beginning of the year (deflated for the rise in the price index). Then this was compared with the opening inventory at the retail prices prevailing at the beginning of the year. In that way you can see it was possible to identify in the aggregate: you could say whether you had the same amount at the end of the year, or more or less than at the beginning, because you had your goods on a comparable basis, i.e., the retail price level in effect at the beginning of the year. Then a sufficient quantity was eliminated from the closing inventory to equal the opening inventory, and the remainder was then put back on the actual retail method by multiplying by 110%, again using our illustrative figure. From then on, it was very easy, because you just applied the usual retail method rules to the balance and used your net percentage of mark-on for the year, in order to reduce the additional quantities in the inventory to cost. In that way you may combine the LIFO method with the retail price method and have an inventory that reflects the effect of both methods.

It isn't used in too many instances, but I have gone into it to this extent because a number of persons have asked me about the Hutzler Brothers case and there seemed to be some confusion as to just what it stood for. In my opinion, it means you don't have to identify specific items to use LIFO, and you may use the retail method if you can deflate your closing retail price to the opening retail price so that the items are comparable.

IV. Leasehold Improvements

As to leasehold improvements, I am sure you all know that when you make permanent improvements or substantial improvements to property you cannot take a current deduction. Yet you must be able to get back your cost. For that purpose, one of two types of deduction is usually taken: either amortization of the leasehold improvements over the life of the lease, or ordinary depreciation based on the life of the improvement, whichever period is shorter.

The principal question that has come up on this is in connection with renewals. The Bureau, many years ago, used to look at the lease in a problem of leasehold improvements, and if it found an option to renew, it would add that right onto the original term of the lease and reduce the deduction claimed in the year. It was similar to the de-

[5] 8 T.C. #3, Docket #4683, Jan. 14, 1947.

preciation reduction which was often effected in that way.

However, the Regulations now provide for a different treatment and one I think is more realistic.[6] You do not have to take a renewal option into account, unless it has been exercised, when obviously it is part of the current term, or when the circumstances indicate reasonably that it will be exercised. Under any other conditions, it isn't necessary to add that onto the current period and get a long term over which to amortize the facilities.

If the term of the lease is longer than the life of the improvements, the Regulations provide that you may take the ordinary depreciation deduction. You simply write off the improvement, over the useful life, by any of the approved methods, of which the most commonly used is the straight-line method. Simply divide the cost (by appropriate methods) over the remaining years of the life. However, if the period of the lease is less than the useful life of the asset, you may use a shorter period and take a deduction for amortization over the period of the term—either the original term, or including a renewal when it has been exercised or reasonably is expected to be exercised.

There is one other feature in connection with leasehold improvements where the landlord and the tenant are affiliated corporations. In such cases, the Bureau is skeptical about the term of the lease, whether it has renewal options or not, and there you will be obliged to use the life of the facilities rather than the term of the lease. That is one of the usual precautions to avoid manipulation where there are controlled taxpayers—about which I will say a little more under the next topic in the few minutes that remain.

Now, incidentally, there are two other items to mention in connection with this subject: If there is an indefinite tenancy, that is, no definite period is fixed for the termination of the lease, or it may be on a year-to-year basis without any particular understanding, then the life of the improvement must be used. It can't be written off in one year on the ground that the lease may not be renewed for another period. On an indefinite tenancy, you disregard the term of the lease. The other item of interest to us is where there is an obligation to restore the property—in other words, to turn it over to the landlord in its original condition: then, instead of a deduction for depreciation or amortization, you take an annual deduction for your costs of restoring or repairing the property to keep it in its proper condition.

V. Section 45, I.R.C.

As to our third topic—I.R.C., Section 45—it is interesting to note that this may be invoked only by the Commissioner. It is one of the sections in the law that is strictly one-way: it is not there for the benefit of the taxpayer, it is not a relief provision; in its nature it may almost be said to be a penalty provision. And, wherever there are related taxpayers, regardless of their form[7] (whether individuals, partnerships, corporations, even trusts), the Commissioner may reallocate the items of income, deductions, credits and exemptions, in order to clearly reflect the income. The only test that the Commissioner follows is to see that the income is clearly reflected, as it would have been if the taxpayers had been unrelated companies dealing at arms'-length.[8]

Now that test is so vague that there isn't much you can do about it at the time an examination is being made. In one case with which I am familiar, one of our very large corporations had a set-up something like this:

There were a number of separate subsidiary corporations in various States doing manufacturing. They

[6] Sec. 29.23(a)-10, Reg. 111.

[7] Section 29.45-1(a), Reg. 111.

[8] Section 29.45-1(b), Reg. 111.

would sell all of their product, at certain predetermined mark-ups, to a central coordinating organization—another related corporation. This corporation, in turn, would sell the product to a number of other related selling corporations that were organized for various legitimate, bona fide purposes—in fact, everything was legitimate and bona fide, and yet that has nothing whatever to do with the imposition of Section 45; the law expressly states that: that, whether by inadvertence or design, it doesn't matter how unintentional, the Commissioner may still come in with this section.

It appeared that the percentage of mark-up on the manufactured product to the central company had been changed from time to time, over the period of a few years, and that the rates of discounts given to the selling companies had similarly been changed from time to time, over the same period, and that was enough to permit the Bureau to go in and decide what the percentage should have been throughout the period and to recommend very large deficiencies in tax.

And so, relating Section 45 to our topic of Retail Chain Stores, the principal item I have come across here has been the home office expense, as it is often called: the general managerial supervision, executive expenses, sometimes including centralized buying expense, styling, merchandising, et cetera. In distributing that expense to the various stores, it is necessary to be very careful to use a proper basis, because where there is a relationship, the Commissioner will often find ways of reallocating the percentage so that the corporations with the larger profits do not necessarily get the largest deductions for home office expenses.

VI. Conclusion

Now, in conclusion, I would just like to say that there are many other problems in connection with retail chain stores. There are other problems in connection with inventories—such as internal control, pricing, et cetera; but we don't have time to go into them in the short industry papers that we give, and so I think we will have to leave the subject at this point.

A Review of Chain Store Taxation

By James Harte Levenson

The history of taxation conclusively demonstrates that when new taxes are devised and prove fruitful, they spread like a forest fire. The history of taxes aimed at chain stores abundantly proves that point. The first such tax to be sustained as constitutionally levied was the Indiana tax enacted in 1929 and upheld by the Supreme Court in 1931. Since then twenty-five states and two cities have enacted such taxes, of which nineteen state laws and two city ordinances are now in force.

With the increasing demands that were made upon state budgets during the years from 1929 to the commencement of the war and the slow but sure saturation point that was being reached with respect to other taxes, these taxes spread. While the war caused a virtual cessation of new state taxes, because of the needs of the federal government, it is not unlikely that more states will find it necessary to resort to chain store taxes to meet post-war burdens that are again falling to the states. At this point it would not be amiss to mention that these taxes are enacted both because of enmity toward chain stores, particularly food and drug companies, as well as because of the desire to raise revenue. The precise proportion in which these elements enter into consideration is impossible of appraisement. However, in those states where anti-chain store regulation is permissible as regulatory legislation and not as a tax measure, the statute recites that its purpose is to regulate chains. Contrariwise, in those states where the legislation may only be enacted as a revenue raising the measure, the statute with equal solemnity describes itself as a revenue raising measure. As far as chain stores are concerned, a dollar paid under one statute is equal to a dollar paid under the other.

JAMES HARTE LEVENSON is a member of the New York Bar and is secretary and treasurer of American Budget Corporation. He is an Associate Member of the Committee on Federal Excise and Miscellaneous Taxes of the Section on Taxation, American Bar Association. He is a contributor to professional journals and formerly was instructor in law at Pace Institute.

The purpose of this review is to consider which taxes have been sustained as lawful, which have been rejected as unconstitutional and to determine the various patterns which they follow. An attempt will also be made to determine the direction in which they will travel in the future.

The Indiana State Tax

Prior to 1929, a few sporadic attempts were made to tax chain stores, but those laws were held to be unconstitutional. The first anti-chain store tax to be upheld, as hereinbefore stated, was Chapter 207 of the Acts of 1929 of Indiana, which was sustained by the Supreme Court of the United States in the now famous case of *State Board of Tax Commissioners of Indiana* v. *Jackson,* 283 U. S. 527. Since this law is the forerunner of all that followed, we shall consider it in some detail. The statute there provided that it was unlawful to operate a store in Indiana without obtaining a license. The license fee for operating one store was $3 a year. If more than one store was operated in the state under the same ownership, management or control, the license fee ascended by brackets. It is important to note that only the stores within the state are taxed and considered in determining the brackets and, moreover, that the rates are not retroactive, i. e., as the chain increases in size, only the additional stores are taxed at the higher rate.

The act was attacked as unconstitutional as constituting an arbitrary and

capricious classification, since the number of roofs under which a taxpayer operates is not a guide to his ability to pay taxes. Thus the taxpayer showed that there were two department stores in the state, each of which had an annual volume in excess of eight million dollars and were required to each pay a tax of only $3 a year. Jackson, the taxpayer, operated 225 food stores in the state and transacted only a little over one million dollars worth of business a year. Based upon the progressive rate he was required to pay $5,443 a year. The Court brushed aside this argument and stated that the evidence showed that chain stores had tremendous advantages over independent operators consisting (among other things) of mass buying, ability to obtain cash discounts by reason of volume buying and ample cash, skill in buying, unified operation and concentration of buying in certain departments. The Court further discounted the fact that department stores may have a greater volume of business because it is spread over many departments and hence specialization does not exist in any one department. The Court was not concerned with whether the precise classification made by the legislature was correct, it being sufficient that the Court found that a difference existed between chain stores and independents, and when such a difference exists, it is for the state legislature to determine the tax classification. Whatever one may think of this decision, there is no question that today it constitutes the law.

Thirteen states have adopted the Indiana kind of tax with minor variations, i. e., a tax which increases by brackets and takes into consideration only the stores within the state.

The Louisiana Type of Tax

Thus far we have considered progressive, increasing rates of taxes, but measured solely by the number of stores within the taxing state. In 1932, Louisiana enacted a tax upon chain stores (and amended in 1934) which drastically increased the obligations of chains. It was similar to the Indiana tax in its first principle in that it levied a tax which graduated upward with the number of stores and the tax was levied only against those stores in the state. However, in determining brackets there were taken into account all of the stores of the chain irrespective of where they were located. The rates started at $10 from two to ten stores and sky-rocketed upward through fifteen additional brackets. The final bracket provided for a tax of $550 per store for more than 500. The A. & P. operated 106 stores in Louisiana and a total of 15,082 throughout the United States and Canada. If only the stores in Louisiana were considered in determining the tax bracket, the tax would be at the rate of $50 a store, or a total of $5,300, but under the statute, since more than 500 units were operated by the A. & P., both within and without the state, the tax was at the rate of $550 a store, or $58,300.

The A. & P. contested the constitutionality of the statute, but finally, in 1937, the Supreme Court in a 4 to 3 decision sustained the tax in *Great Atlantic & Pacific Tea Co. v. Grosjean*, 301 U. S. 412. The opinion of the court is significant. It found that the opportunities of a chain increased with the growth of the number of units which reflected itself in benefits to each unit. Accordingly, it was justifiable for the state to count all the units irrespective of their location to determine the taxable bracket since only the units in the state were taxed.

More significant is some of the language of the court. No attempt was made to justify the tax as a revenue raising measure; it was frankly defended as an attempt to regulate chain stores as an evil in themselves. The court stated that the state could forbid or regulate business so as to abate its evils, and that which the state may regulate or forbid, it may sanction upon

the condition of a fee so as to mitigate its evils.

This decision shortly bore fruit. Taxing statutes modeled on Louisiana were rapidly enacted and are in force in Florida, Mississippi and South Dakota.

Florida's Anti-Chain Laws

Florida has had a checkered career in the enactment of taxation of chain stores. In 1931 it enacted a graduated chain store tax somewhat similar to the Indiana tax, but assessed the tax at higher rates if the stores were located in more than one county in the state. The tax was sustained insofar as there were progressive rates for an increased number of stores, but void insofar as it differentiated between stores in one county or more than one. The Court laid down the rule that county lines within the state offered no valid line of demarcation. The statute also allowed municipalities to tax stores within their boundaries. That phase of the law was upheld.

Florida was not content with this decision and sought other avenues to increase the burden on chains. It thereupon enacted a law containing two elements:

(a) A progressively graduated tax based on the Indiana type.

(b) In addition, there was a second schedule which levied a monthly gross receipts tax which remained constant for each store, but increased in rate with the number of stores.

The validity of this statute was first questioned in a suit in the federal courts (*Lane Drug Stores* v. *Lee*, 11 Fed. Supp. 672). The graduated gross receipts tax was held void under the authority of *Stewart Dry Goods* v. *Lewis*, 294 U. S. 550 (1935). However, Schedule "a" was sustained as a valid chain store tax.

What Constitutes Common Management or Control?

The draftsmen of all of the statutes recognized the fact that chain store operators in a desire to minimize these taxes would resort to various devices such as creating a number of subsidiaries, leasing stores to the managers and operating under license systems and in other ways. Consequently, all of the laws contain language to the effect that the tax is levied not only upon stores "owned" by the same person, firm or corporation, but also upon units "operated", "controlled" or "managed" by the same interests. It, therefore, becomes important to ascertain what constitutes common management or control.

The courts have given a very broad definition to those terms and have sustained the tax wherever the taxpayer denied control. It has been held that the control need not be legal control and it is sufficient that there merely be an integrated number of units. A few cases will illustrate the point.

In *Gulf Refining Co.* v. *Fox*, 11 Fed. Supp. 425, a lower federal court considered the West Virginia statute. Gulf Refining Co. itself operated a number of gasoline stations and also granted licenses for so-called Authorized Dealer Agencies (A. D. A.) and what it termed Authorized Licensed Dealers (A. L. D.). The company admitted that the former were taxable to it since those operators sold Gulf's products on a percentage basis. It, however, resisted the tax as to the A. L. D. units. The licensing arrangement for the A. L. D.'s were substantially on the following basis. The dealer would lease his premises to Gulf which would grant him a license to operate a Gulf station at that location; the rental was usually a percentage of the gasoline and oil products; Gulf loaned the equipment to the dealer and painted the station in the distinctive Gulf gas station colors; the dealer agreed to buy his gasoline and oil from Gulf, but was permitted to buy elsewhere tires and like products which were not produced by Gulf; Gulf could cancel the franchise on twenty-four hours notice, but in that case had to repurchase the wares on hand; the

licensee agreed to "push sales" of Gulf products; Gulf had an option to purchase the premises at a fixed price; there were minimum purchase requirements; products were sold to the retailer at the same price as Gulf's retail price, less a fixed discount; most dealers paid C. O. D.; dealers honored Gulf's credit courtesy cards and were reimbursed by Gulf; Gulf suggested the retail price which was uniform in a competitive area; Gulf's tank delivery men supervised the stations and made "suggestions" for uniform operation; the dealer hired and paid his own help, pocketed his own profits and bore his own losses. It was conceded by the state that Gulf did not institute this system to evade taxes, but that it was in existence before anyone dreamt of chain store taxes. Nevertheless, the court sustained the tax. In its opinion it pointed out that Gulf "controlled" the stations, not in a legal sense such as exists between parent corporation and subsidiary, but in the sense that the contract gave Gulf effective control over the operations of the independently owned stations. It is significant that the court placed its emphasis upon the fact that the stations were part of an integrated system; that the passing motorist thought of them as a chain.

The same court simultaneously considered the chain of another refining company and reached the same conclusion (*Ashland Refining Co.* v. *Fox*, 11 Fed. Supp. 431). In this case, the company showed that its agency agreements differed from those of Gulf. The essential difference was that the cancellation privilege was mutual so that either party could exercise the same and in addition, 10 days' notice had to be given to exercise the same. The court deemed these distinctions immaterial, contending that the company in fact was in a position to "control" its authorized dealers.

These two cases went to the Supreme Court which affirmed the decisions (*Gulf Refining Co.* v. *Fox*, 297 U. S. 378). That court refused to review the evidence, contenting itself with pointing out that the question was solely one of determining the state's intention in using the term "control", and that the finding of fact by the lower court would not be disturbed since there was evidence to support it.

In Michigan it was held that subsidiaries are controlled by the parent (*C. F. Smith Co.* v. *Fitzgerald*, 270 Mich. 659).

In *Belk Bros.* v. *Maxwell* (215 N. C. 10) North Carolina was upheld in its efforts to tax the Belk stores and the United States Supreme Court refused to review that decision (307 U. S. 644). The North Carolina act recited that chain stores included separate corporations if there is common ownership of majority stock and/or similarity of name of such companies and/or if the companies have the benefit in whole or in part of group purchase of merchandise or of common management.

There were 46 stores in the state, all of which bore the name "Belk" in part. With a few minor exceptions, they owned no stock in each other. W. H. Belk owned stock in each one, and with two exceptions did not own a majority in any company. He was the president and a director of each, but otherwise the directors were different people.

The purchasing public thought of all the stores as "Belk" stores; they all sold "Belk" brands; used a distinctive kind of wrapping paper; and each furnished Belk with weekly sales figures. An accountant was jointly engaged by all of the stores, whose expenses were pro-rated. Similarly, they maintained a joint New York buying office, with a pro-ration of the expenses, although the stores were permitted to make individual purchases.

The court held that they were part of a chain and were all taxable as such. Indeed, the court frankly stated that the original act had been amended so as to make the Belk plan subject to the tax. The court continued saying that all of the advantages inherent in a chain

existed, i. e., they constituted an integral group, and consequently they were taxable as such.

A somewhat similar case arose in Colorado (*Bedford* v. *Gamble-Skogmo, Inc.*, 104 Col. 424 (1939)). In addition to operating its own stores, the taxpayer sold its merchandise to independently owned stores under a uniform sales contract. This agreement, in substance, permitted the stores to be painted with the distinctive Gamble stores colors; to call it a "Gamble Store Agency"; the store agreed to push Gamble merchandise; Gamble advised on merchandising policies; furnished circulars; Gamble reserved the option to buy the fixtures and repurchase the merchandise at the end of the term; and to take over the lease. In addition, the agencies conducted uniform contests; replaced defective merchandise bought from any one of the other agencies; and maintained a uniform credit policy. Merchandise was sold to those stores by Gamble at retail, less a fixed discount for varying classes of merchandise.

The court found that there was an "intimacy of regulation" by Gamble and a willingness to submit by the operators. That was held to be sufficient to constitute "ultimate" control by Gamble within the meaning of the statute and these agencies were taxable, although the court conceded that there was not full legal control. The court further stated that all of the advantages of a chain existed and the arrangement was merely an attempt to obtain immunity. The court also differentiated between true voluntary cooperatives where all members have mutual rights, without a dominant licensor, from the arrangement that existed here permitting Gamble to exercise dominion over the agencies.

Thus it will be seen that states will be allowed a great deal of latitude in determining what constitutes a "chain"; in determining what constitutes common management and control and in determining proper classification so as to bring certain classes within the purview of the tax.

Some Miscellaneous Considerations

In some states chain store taxes have been found to be unconstitutional subsequent to the Indiana decision upon the ground that they contravened the constitution of the particular state.

In Pennsylvania a chain store tax of the conventional Indiana type was enacted, but was invalidated by the Supreme Court of Pennsylvania in *American Stores Co.* v. *Boardman*, 6 Atl. (2) 826 (1939), because the constitution of that state expressly provides for "uniformity" of taxes, and the courts of Pennsylvania have uniformly held that any graduated tax is unlawful in that state. In passing, it is interesting to note that graduated income and inheritance taxes are likewise prohibited in Pennsylvania.

Kentucky enacted a chain store tax modelled upon the Indiana tax. It was found to be invalid (*Great Atlantic & Pacific Tea Co.* v. *Kentucky Tax Comm.*, 278 Ky. 367 (1939)), because the Kentucky constitution expressly requires that taxation be uniform on all property of the same class. The court found that retail stores, whether independently owned and operated or part of a chain, constituted one class for tax purposes.

Thereafter the Kentucky legislature enacted Chapter 174 of the Acts of 1940, which was a chain store tax of the Louisiana type. To by-pass the earlier adverse decision, this act recited that its purpose was to regulate chain stores. In *Reeves* v. *Adam Hat Stores, Inc.*, 198 S.W. (2) 789 (1946), rehearing denied February 7, 1947, this act was likewise found to be unconstitutional. The Kentucky Court of Appeals applied the realistic test that the act in fact was a taxing measure, even though it claimed to be enacted solely for the purpose of regulating chains.

In 1933, Minnesota enacted a law

combining the features of the Indiana tax graduated by the number of stores and also imposing a graduated gross receipts tax. The state courts sustained the former but invalidated the latter as unconstitutional. The case then went to the United States Supreme Court. As it was not clear whether the state court's action was based upon state or federal grounds, the Supreme Court declined to pass upon it, stating that if the decision were based upon the Minnesota constitution, the United States Supreme Court had no jurisdiction (*Minnesota* v. *National Tea Co.*, 309 U.S. 551). The case was remitted to the state Supreme Court, which clarified its decision by holding the gross sales feature unconstitutional on state grounds (*National Tea Co.* v. *Minnesota*, 294 N.W. 230 (1940)).

While this case was pending, the state legislature passed a new law omitting the graduated receipts tax, increasing the chain store tax and imposing a similar tax on mail order houses, but at higher rates. This statute by its terms, expired January 1, 1941. Its validity was sustained in *C. Thomas Stores* v. *Spaeth*, 297 N. W. 9 (1941).

Wisconsin had a similar statute to raise revenue during the depression period. That law expired by its own terms on July 1, 1939.

There are several statutes in force in some of the states that are not true chain taxes, but which are sufficiently analogous to deserve comment.

The Tennessee statute is such an instance. Its parentage cannot be traced. It is more just than most of these laws. In that state a tax is imposed upon each store in excess of one and the rate is $3 for each 100 square feet of floor space. It will be noted that the rate is not progressive, and no attempt is made to relate the tax to the total number of roofs under which a merchant does business, but only to the aggregate floor area, which presumably relates directly to the volume of business transacted. The statute, however, imposed a higher rate of taxes on foreign corporations. That feature was invalidated in *Great Atlantic & Pacific Tea Co.* v. *State Court of Chancery*, July, 1939, Davidson County.

The Delaware law defies classification. A tax is levied upon all corporations whose principal place of business is without the state and which maintain branch stores or distributing depots, either wholesale or retail, at the rate of $10 a year plus $.10 on each $100 of the cost of goods received in the state in excess of $5,000.

Summary

In the appendix there is set forth a tabulation showing what states have or have had chain store taxes, and the kind of tax now in force. It will be noted that there are presently 19 such state taxes and two city taxes. Only Maine, California and Utah have repealed their chain store taxes. Wisconsin and Minnesota allowed them to expire as they had been enacted as temporary measures.

Whether there will be a resurgence of chain store taxes will depend upon the needs for revenues of the various states and the degree of saturation of other taxes. In any event, they constitute a substantial burden, and will continue so.

APPENDIX

Summary of Chain Store Taxes; States not appearing on this list, do not have and never have had Chain Store Taxes.

	Type of Tax	Statutory Sources
Arizona	Repealed	
Alabama	Indiana type	Secs. 620-629, Title 51, 1940 Code
California	Repealed	
Colorado	Indiana type	Chap. 161, Colo. Stat. Ann., 1935
Delaware	Based on cost of goods received in state; see text	Chap. 6, Art. 14 et seq., Del Rev. Code, 1935
Florida	Louisiana type, plus tax on inventory in state	Chap. 20977, Acts of 1941
Georgia	Indiana type	Act 355, Laws of 1937
Idaho	Indiana type; with credit for real, property taxes	Chap. 113, Laws 1933
Indiana	Indiana type	Chap. 207, Laws of 1929, as amended
Iowa	Indiana type	Chap. 329.5, Code 1939
Kentucky	Unconstitutional; discussed in text	
Louisiana	Louisiana	Dart's Louisiana Gen. Stat., 1939, Secs. 8664-8674; as amended by Act No. 51, Laws 1934
Maine	Repealed	
Maryland	Indiana type; plus Traders' License Tax measured by inventory	Secs. 1-7, 40-73, 97-102, Art. 56, Ann. Code, 1939
Michigan	Indiana type	Pub. Act No. 265, Laws of 1933, as amended by Pub. Act No. 177, Laws of 1935
Minnesota	Original tax held unconstitutional; subsequent act expired in 1940; discussed in text	
New Mexico	Invalidated	
Mississippi	Louisiana type	Title 37, Chap. 1, Code of 1942
Montana	Indiana type	Secs. 2421.1-2421.12, Rev. Codes
North Carolina	Indiana type	Secs. 105-98 and 105-99, Gen. Stat.
Oregon	No state tax; City of Portland has one of Indiana type	Sec. 20-8802, Portland Ordinances
Pennsylvania	Unconstitutional; discussed in text	
South Carolina	Indiana type	Act No. 829 of 1930
South Dakota	Louisiana type	Chap. 57.34, Code of 1939, as amended by Chap. 273, Laws of 1939
Tennessee	Based on floor space	Item B, Gen. Rev. Acts
Texas	Indiana type	Chap. 400, Laws of 1935, 1st Called Sess.
Utah	Rejected by referendum	
Vermont	Invalidated	
Virginia	No state tax; City of Charlottesville imposes flat tax on sales of chain stores	Sec. 296, State Tax Code; as implemented by local ordinance
West Virginia	Indiana type	Chap. 36, Laws of 1933
Wisconsin	Expired July 1, 1939	Sec. 76.75, Stat.

1947 Changes in the New York Unemployment Insurance Law

By Stanley B. Tunick, C.P.A.

The legislature of New York State during its 1947 session made some significant changes in the law affecting unemployment insurance. The five most important of these changes were (1) employment by the state; (2) the restatement of the $3,000 wage limitation; (3) the restatement of the meaning of wages and remuneration paid; (4) credits against taxes due; and (5) reports, penalties, and interest for late payments. Of these, the credits against taxes due is the most involved, but all five will be taken up in the order named.

1. Employment by the State

Chapter 507 of the Laws of 1947, effective June 2, 1947, included the State of New York in the definition of an employer for the first time. Section 5 of that chapter provides that benefits based on wages paid by the State will become payable beginning with the 1947 benefit year. In lieu of quarterly contributions, the State will pay into the Fund the amount paid out in benefits based on previously earned State wages.

Stanley B. Tunick, C.P.A., is a partner of Tunick and Platkin, C.P.A.'s. He is also a member of the New York Bar. Dr. Tunick is Assistant Professor of Accountancy at the School of Business and Civic Administration, The City College, New York.

He is a member of the Society's Committees on State Taxation and Local Taxation, and is a collaborator with the editorial staff of Prentice-Hall, Inc., on their New York Tax Course.

2. Restatement of the $3,000 limitation

Prior to 1947, "wages" meant the first three thousand dollars of remuneration paid to an employee by each of his employers for work performed in New York State. Chapter 205 of the Laws of 1947 defines "wages" as "all remuneration paid, except that such term does not, as of January 1, 1947, include remuneration paid to an employee by an employer after three thousand dollars have been paid by such employer with respect to employment during any calendar year." Wages paid for employment under another State or Federal unemployment insurance law will be included in establishing the $3,000 taxable wage limitation, provided such other law accords similar treatment to wages for employment under New York law.

3. Restatement of the term "wages and remuneration paid"

The term "wages and remuneration paid," according to Chapter 269 of the Laws of 1947, may for any purposes of the Unemployment Insurance Act as the Commission prescribes, include not only wages paid, but also wages earned but not yet actually paid. The date on which such wages are deemed paid shall be fixed in accordance with rules or regulations which the Commissioner may prescribe.

4. Credits Against Taxes Due

The amount of merit credit to which an employer may be entitled against unemployment taxes due by him in New York State will hereafter, under the laws of 1947, be based primarily upon (1) the amount claimed as benefits by

former employees, (2) decreases in remuneration paid by employers in successive calendar quarters, and (3) the number of years during which unemployment insurance contributions have been paid. The composite of these three factors will determine the credit class in which an employer is placed, and this credit class will in turn determine the portion of surplus available as a credit to which an employer is entitled.

The details of computations that will be made in order to arrive at the exact amount of credit is set forth below. Some of these are from old law; others represent 1947 changes. Because the 1947 changes, standing alone, may not be easily understood without reference to old law, the old and the new are presented as an integrated whole. In order to understand the computations and the methods followed in working them out, it is necessary that terms used in the law be properly understood.

"Computation date" has been changed from January 1 (used in the old law) to the first Monday in June of any year. (Chapter 809, Laws of 1947).

"Effective date" has become September thirtieth next following the computation date, instead of June 30. (Chapter 809, Laws of 1947).

"Qualified employer" means an employer who in each of the seventeen consecutive completed calendar quarters immediately preceding the computation date was required to file and did file all contribution reports which were prescribed, including reports of remuneration paid in each quarter beginning with 1945, on or before the effective date. The change (Chapter 809, Laws of 1947) became effective on April 11, 1947. Previously, the law required filing for only thirteen calendar quarters prior to the computation date. If an employer has acquired the assets of another employer who thereafter has discontinued operations, the period of liability of both employers shall be jointly considered in determining the acquiring employer's qualification for and amount of credits. The period of liability of such other employer prior to the date of transfer of assets shall not thereafter be taken into consideration in determining his qualification for and amount of any credit (Chapter 780, Laws of 1947).

"Surplus," as defined in the statute (Chapter 809, Laws of 1947) has been changed to mean the amount by which the moneys in the fund as of the effective date, after subtracting the amount of credits previously established and outstanding as valid on such date, exceed three and a half (previously four) times the amount of contributions payable on the payrolls reported by all employers on or before the effective date for the preceding completed calendar year, limited to an amount not greater than sixty per centum of such contributions for such year.

"Wages of compensated employees" is a term first introduced by the laws of 1947 (Chapter 809). They refer to the wages paid during the applicable base year to any claimant who has received benefits for sixteen or more effective days in the corresponding benefit year.

"Employer's wages of compensated employees" is another term used for the first time in 1947 (Chapter 809). This means for each employer the total of the wages of compensated employees paid by him for the three base years corresponding to the three benefit years immediately preceding the computation date.

"Benefit experience index," also mentioned for the first time under the laws of 1947 (Chapter 809), means for each employer the ratio determined by dividing his employer's wages of compensated employees by the total of the wages paid by him for the three years corresponding to the three benefit years immediately preceding the computation date. Such ratio shall be computed to the third decimal place.

"Employer's experience factor," as restated and changed by Chapter 809 of the Laws of 1947, represented by the figure established as follows:

a. Each qualified employer is first assigned the figure, designated below as benefit factor, which is listed on the same horizontal line on which such employer's benefit experience index appears.

Benefit Experience Index	*Benefit Factor*
Less than .04	12
.04 or more but less than .05	11
.05 " " " " " .07	10
.07 " " " " " .08	9
.08 " " " " " .09	8
.09 " " " " " .11	7
.11 " " " " " .12	6
.12 " " " " " .13	5
.13 " " " " " .15	4
.15 " " " " " .16	3
.16 " " " " " .17	2
.17 " " " " " .18	1
.18 or more	0

b-1. The sums of the quotients of quarterly decreases of remuneration in regard to the three consecutive calendar years immediately preceding the computation date shall be established, each such quotient to be obtained by dividing any decrease of the total remuneration paid by a qualified employer to all his employees in any calendar quarter from the preceding quarter by the amount of the total remuneration paid by him to all his employees in such preceding quarter, each division being carried out to the fourth decimal place. The following applies to the period preceding January 1, 1945:

b-2. Decreases of total wages shall be taken into consideration instead of decreases of total remuneration, unless the employer reports by a date to be prescribed by the commissioner the amount of total remuneration paid by him to all his employees in each of the calendar quarters in regard to any of such three consecutive calendar years falling before such January first. Such date shall not be earlier than thirty days after the enactment of this provision. An employer who knowingly makes an incorrect report of such remuneration shall be guilty of a misdemeanor. The distinction made between wages and remuneration is that wages is the less inclusive term, representing only the first three thousand dollars of remuneration paid to an employee by an employer for employment during any calendar year.

b-3. Each qualified employer shall be assigned that figure, designated as quarterly factor, which is listed below on the same horizontal line on which the sum of such employer's quotients of quarterly decreases of remuneration appears.

Sum of Quarterly Decrease Quotients	*Quarterly Factor*
Less than 0.5	6
0.5 or more but less than 1	5
1 " " " " " 1.5	4
1.5 " " " " " 2	3
2 " " " " " 2.5	2
2.5 " " " " " 3	1
3 or more	0

c. In accordance with the years of liability for contribution, each qualified employer shall be assigned that figure, designated as age factor, which is listed below on the same horizontal line on which there appears the number of full consecutive calendar years preceding the computation date during which the employer has been liable for contributions.

Years of Liability for Contributions	*Age Factor*
8 years or more	5
5 years or more but less than 8 years	4
Less than 5 years	3

d. The sum of the qualified employer's benefit factor, quarterly factor and age factor constitutes such "employer's experience factor."

"*Class weight*" means the figure assigned to each credit class, as set forth below:

Credit Class	*Weight*
I	5
II	4
III	3
IV	2
V	1
VI	0

"*Class product*" means the figure obtained by multiplying the class weight by the quotient resulting from dividing the total of payrolls of all employers in

the same class by the total of payrolls of all qualified employers for the calendar year immediately preceding the computation date, such division being carried out to the fourth decimal place and the remaining fraction, if any, disregarded.

"Class credit factor" means the quotient obtained by dividing the portion of the surplus assigned to any class of qualified employers by the sum of such employers' payrolls in that class for the calendar year immediately preceding the computation date, such division being carried out to the fourth decimal place and the remaining fraction, if any, disregarded; provided that the maximum class credit factor to be assigned to a credit class shall be as follows:

Credit Class	*Maximum Class Credit Factor*
I	.0220
II	.0176
III	.0132
IV	.0088
V	.0044
VI	.0000

Employers' Credit Classes

Qualified employers shall be grouped into six credit classes, to be designated as classes I, II, III, IV, V, and VI, respectively, in accordance with their experience factor.

Employer's Experience Factor	*Credit Class*
20-23	I
16-19	II
12-15	III
8-11	IV
4-7	V
3	VI

Establishment of Credits

(a) There shall be assigned to each of the classes numbered I to V such portion of the surplus which bears the same ratio to the surplus as the class product of such class bears to the sum of the class products of all classes. No portion of the surplus shall be credited to class VI.

(b) The credit to which an employer in each of classes I to V shall be entitled shall be an amount determined by multiplying his payroll in the calendar year preceding the computation date by the class credit factor of his class.

(c) A surplus shall not be credited to any employer if the amount of the surplus is less than ten per centum of the amount of contributions payable on the payrolls for the calendar year preceding the computation date reported on or before the effective date by all employers.

A determination of credits against taxes due may be summarized by the following equations and statements:

(1) $\textit{Benefit Experience Index} = \dfrac{\text{Employer's Wages of Compensated Employees}}{\text{Total of Wages Paid}}$

(2) *Benefit Factor* is the result of the conversion of item (1).

(3) $\textit{Quotient of Quarterly Decrease} = \dfrac{\text{Decrease of Total Remuneration in Quarter From Preceding Quarter}}{\text{Total Remuneration in Preceding Quarter}}$

(4) *Quarterly Factor* is the result of the conversion of the sum of quotients such as are described in item (3).

(5) *Age Factor* is determined by the years of contribution liability.

(6) $\textit{Employer's Experience Factor} = \left\{\begin{array}{l}\text{Benefit Factor} \\ \quad\text{plus} \\ \text{Quarterly Factor} \\ \quad\text{plus} \\ \text{Age Factor}\end{array}\right.$

(7) *Credit Class* is the result of the conversion of Employer's Experience Factor.

(8) *Class Weight* is the result of the conversion of the Credit Class.

(9) $\textit{Class Product} = \text{Class Weight} \times \dfrac{\text{Total Payroll of All Employers in Same Class}}{\text{Total Payroll of All Qualified Employers.}}$

(10) $\left.\begin{array}{l}\textit{Portion of Surplus}\\ \textit{Assigned to Credit}\\ \textit{Classes}\text{, except Class VI}\end{array}\right\} = \text{Surplus} \times \dfrac{\text{Class Product of Any Class (except Class VI)}}{\text{Sum of Class Products of All Classes.}}$

(11) $\textit{Class Credit Factor} = \dfrac{\text{Portion of Surplus Assigned to Any Class of Employers}}{\text{Sum of such Employers' Payrolls in that Class.}}$

(12) $\left.\begin{array}{l}\textit{Credit Assigned}\\ \textit{to each Employer}\end{array}\right\} = \text{Employer's Payroll} \times \text{Class Credit Factor of his Class.}$

Notice, application and transfer of credits

(a) Each qualified employer shall, as soon as practicable after the effective date, be furnished a notice showing the amount of credit to which he is entitled. The amount shown on the notice may be applied against contributions which are payable on wages paid in the four consecutive calendar quarters beginning after the effective date, and reported not later than thirty days after the date prescribed by the commissioner for payment of contributions on wages paid in the last of such quarters.

(b) If prior to the expiration of such thirty days an employer notifies the commissioner that he has acquired all or substantially all the assets of another employer and such other employer has discontinued operations upon such acquisition, any unused portion of the credit to which such other employer is entitled shall be transferred to the acquiring employer. No credit shall be otherwise transferable by any employer to his successor or anyone else. Administrative Interpretation No. 6, issued on May 29, 1947, by the Division of Placement and Unemployment Insurance, explains "unused portion" of the tax credit to be transferred to the acquiring employer as that part of the transferring employer's credit which is valid and outstanding after payment has been made by application of credit to the fullest extent possible of all contributions for which the transferring employer is liable on the basis of wages paid prior to the date of acquisition or April 11, 1947, whichever is later.

Corrections and Modifications

(a) If an employer has been improperly classified, his experience factor shall be recomputed to determine his proper class. If an employer's payroll for the calendar year preceding the computation date has been incorrectly established, the correct amount thereof shall be determined. His credit shall be computed by multiplying his correct payroll in the calendar year preceding the computation date by the class credit factor for his proper class.

(b) Corrections or modifications of an employer's payroll or remuneration paid by him shall not be taken into account for the purpose of an increase of his credit, unless such corrections or modifications were established on or before the effective date.

(c) Corrections or modifications of an employer's payroll or remuneration paid by him shall be taken into account for the purpose of a reduction of his credit only if they were established before the expiration of four years from the last day of the calendar year in which such remuneration or wages determining such payroll were paid, except that they shall be taken into account whenever established if the employer filed false reports with intent to defraud with respect to such remuneration or wages. The limitations referred to were introduced by Chapter 782 of the Laws of 1947.

(d) Increases or reductions of an employer's credit shall not affect the credits established or to be established for any other employer, and shall further not affect any other computation made under the law.

(e) If a credit notice has been issued to an employer whose credit is increased, a supplementary credit notice, reflecting the increase of his credit shall be issued to him. If a credit notice has

been issued to an employer whose credit is reduced, such notice shall be recalled and a revised notice issued. If the credit shown by the incorrect notice has already been applied in excess of the correct credit, the employer shall be liable for payment into the fund of an amount equal to the excess of the credit taken by him over the credit to which he is entitled, and such amount shall be deemed and collected as contributions payable under the law.

Joint accounts

(a) The provisions with respect to joint accounts stem from Chapter 781 of the Laws of 1947, and apply to credits established as of the effective date occurring in 1947 and thereafter, if some of the employees of a qualified employer have been transferred to another employer. However, it is necessary that the functions in which they were engaged and the assets, if any, relating to such functions are also transferred to such other employer, and that further the transferring employer discontinues such functions upon the transfer.

(b) Whenever a partial transfer as described in paragraph (a) above has been made, subject to the conditions set forth in paragraph (d) below, a joint account of the employers involved shall be established by combining their experiences. Such employers shall, for all purposes of this section, be treated as if they had operated as a single employer. The age factor for such joint account shall be established by adding the age factors which apply to each of such employers, whether or not any of them considered separately would be a qualified employer, and by dividing the result by the number of employers involved. The total credit to which such employers are entitled on the basis of their joint account shall be allocated to each of such employers in a manner as agreed by them. If the commissioner has not been advised of such agreement on or before the day as specified in paragraph (d) (i) below, such total credit shall be allocated to each of such employers in the ratio which his payroll during the calendar year preceding the computation date bears to the combined payrolls of all such employers during such year.

(c) Such joint account shall apply only with respect to credits issued:

(i) As of the effective date last occurring before the transfer;

(ii) As of the effective date occurring in the same calendar year in which the transfer takes place;

(iii) As of any effective date occurring in the three calendar years following the year in which the transfer takes place.

(d) As a condition for establishing a joint account by combining such employers' experiences:

(i) They must request the commissioner that the provisions of the law referred to be made applicable to them. Such request must be made not later than the last day on which wages must have been reported in order that credits may be applied against contributions due thereon in accordance with the provisions set forth under "notice" application, and transfer of credits herein above; and

(ii) If a joint account, as provided, has been established, and partial transfer by or to any other employer has been made involving any of the employers whose experiences has been combined, such other employer and the employers whose experiences have already been combined may request that a joint account for all such employers be established. Such request must be made by all such employers within the period set forth in subparagraph (d) (i) hereof.

(e) A joint account shall not be established, or if established, shall be dissolved whenever before the effective date, any of the employers involved has ceased to be liable for contributions or has become disqualified under this section because of his failure to submit reports or pay contributions as required.

Withholding of credits

If a qualified employer is liable for any payments to the fund which are subject to collection, the notice of credit to which the employer is otherwise entitled shall be withheld, and the credit may not be applied until such deficiency has been paid in full. On or after the effective date, the employer shall be notified in writing of such deficiency and of the fact that this tax credit is being withheld on account thereof. No notice of the credit shall be given and such credit may not be applied if such deficiency has not been paid in full on or before the last day of the calendar quarter which begins after the employer was notified of the deficiency.

5. Reports, Penalties, and Interest for Late Payments

Chapter 605 of the Laws of 1947 provides for interest on contributions due after July 1, 1947, at the rate of three-fourths of one per centum of the amount of such contributions for each month or fraction thereof that they are in default. Previously, the rate was six per centum per annum. The five per centum penalty for negligence without intent to defraud is terminated on July 1, 1947. However, the fifty per centum penalty for fraud remains.

The Act has always provided for prompt notification to the Commissioner of the fact that an employer has become liable for contributions. Previously, he was subject to a penalty of one hundred per centum of the contributions due for failure to comply with these provisions within six months of the event which rendered him liable. The Laws of 1947 (Chapter 605) provide that this liability shall be limited to employers who became liable for contributions before January 1, 1947.

The same chapter also provides for a limitation of the penalty for failure to furnish a payroll report for any calendar quarter upon demand by the Commissioner. Previously, the penalty for such failure was three dollars with respect to each employee with a maximum of five hundred dollars for any quarter. The Laws of 1947 limit this penalty with respect to demands made after March 31, 1947, to five hundred dollars or the contributions paid or payable on the wages paid, whichever is less. Furthermore, the commissioner may under the amended law grant an extension upon request within twenty days after such demand.

General Summary

Perhaps one of the more important changes in the unemployment insurance law affecting the average employer is the reduction of the required reserve in the unemployment insurance fund from four times employer liability for the prior year to three and a half times such liability. Were it not for this change, it is possible that, because of increased employer liability to the fund in 1946, so large an increase in the reserve would have been required under the old law that employers would not have been entitled to any tax credits this year.

Another major change substitutes the consideration of benefit payments received by former employees for variations in the amount of annual payrolls as one of the factors used in determining tax credits.

The third important change is the one which requires that contributions on wages paid in New York by employers subject to the act between July 1, 1947, and September 30, 1947, both inclusive, be paid in full. No tax credit will be applicable to that period because of the change in effective dates. Instead of the former annual credit period from July 1 to June 30, there is now substituted a credit period from October 1 to September 30. Some employers for whom a surplus of unused merit credits was indicated after payment of wages applicable to June, 1947, prepaid in June a portion of wages due in July. This permitted the application of such surplus credits to such prepayment, and avoided the loss of the unused balance.

It is suggested that the postponement of payment of wages due for the third quarter of 1947 to the last quarter, will permit the application of credit under the new law to the taxes payable on such wages when paid.

The changes in the law will result in giving to employers a more equitable share in the surplus which they actually created. Employers can do much to make their share of that surplus greater. First, they should endeavor to stabilize employment; second, they should reduce fluctuations in quarterly payrolls as much as possible; third, they should scrutinize carefully all applications for benefits by their former employers, so that benefits to which they are not entitled will not be paid to them. By doing these things, employers will enable their employees to have more regular employment, and make it possible for themselves to receive the maximum credits against taxes which the law allows.

The Accounting System of War Assets Administration

By Philip J. Wolfson

The major objectives of War Assets Administration are to make surplus property available for the most rapid and economic reconversion of industry and reemployment of labor; to reduce, to the greatest extent possible, surplus inventories for carryover into the post-reconversion period; and to achieve the other objectives of the Surplus Property Act. These objectives are accomplished through sales of surplus property at surplus property location sites, at warehouses, and through approved dealer and industry-agency agreements.

The accomplishment of these objectives is a tremendous task when it is realized that, in the New York region alone, there is over 500 million dollars worth of inventory on hand at the present time, and that sales during the month of December, 1946, were over $30,000,000. There are very few commercial organizations in the world today that are faced with the problems, the need for speed in operations, and the potential public criticism that are characteristic of the operations of the Administration. What type of an accounting system has been established to record and control these prodigious operations?

Philip J. Wolfson, has been associated with the office of The Comptroller General of the United States for several years. He is also an Instructor in Accountancy in the Evening Session of The City College of New York from which institution he holds the degrees of B.B.A and M.B.A. He is a member of the National Association of Cost Accountants.

Scope of System

The chart of general accounts, *pro forma* entries to general accounts, and allotment accounting procedure were prescribed by the Comptroller General of the United States on June 18, 1946, pursuant to the Budget and Accounting Act of 1921. The scope of financial transactions of the administration includes cash collections and disbursements, assets acquired, liabilities incurred, expenses incurred, income accrued, surplus property inventory declared, accountability to owning agencies for such declarations, and all transactions arising out of the custody and disposal of surplus property.

The system prescribed for the War Assets Administration is a specialized one designed to meet the peculiar problems of the Administration in fulfilling its mission as a nationwide agency for speedy disposal of the Government's stores of surplus property. For this reason, the system is not entirely in accordance with the provisions of General Regulations No. 100 governing the administrative appropriation and fund accounting of Federal agencies generally.

Accounting Principles

The accounting principles guiding the development of the accounting system include: the use of double entry accounts; decentralized accounting, with the responsibility for recording financial transactions in the regional office in which such transactions arise; branch office accounting, with the accounts of field offices controlled through reciprocal accounts; accountability to owning agencies, established in the accounts for all surplus property declared; all surplus property sales recorded in receivable accounts; all surplus property sales, surplus

property accountability, inventory, cost of sales, and write-offs of general ledger accounts controlled in accounts for which the supporting detail is contained on punched cards processed by mechanical equipment; all income accrued in general, but expenses recorded on a cash basis; all collections identified in subsidiary cash accounts; and subsidiary allotment accounts controlled in the general ledger. The Washington Office maintains mechanical control and policy control over the accounts in all field offices to facilitate the consolidation of financial statements. Accounts not provided for in the chart of accounts may not be added by any field office without prior approval of Washington office. However, if in the opinion of regional officials, the financial transactions may be accumulated into the accounts in a more efficient and economical manner, it is permissible for them to adapt the form of records already provided, or to design and install additional records with the approval of Washington.

Illustrative Accounts

The chart of general accounts is broken down into asset accounts, liability and accountability accounts, operating accounts, statistical accounts, budgetary accounts and inter-office accounts. Some of the accounts utilized in the New York region are:

211.01 **Asset Accounts**

104 *Disbursing Officer's Cash—Undeposited Appropriation Repayments*

Account 104 is a debit balance (asset) account maintained to show the accountability of the disbursing officer for collections received which are required to be deposited into the Treasury as repayments to appropriations.

105 *Disbursing Officer's Cash—Undeposited General Fund Receipts*

Account 105 is same as 104 except that these collections are required to be deposited into the Treasury as General Fund Receipts.

111 *Disbursing Officer's Cash—Receipts from Surplus Property Disposals*

Account 111 is a debit balance (asset) account maintained to show the accountability of the disbursing officer for collections received from the sale and rental of surplus property.

121 *Receivables — Secured Surplus Property Sales Accounts*

Account 121 is a debit balance (asset) maintained to show the total of amounts due the United States on account of surplus property disposals, where such debts are secured by collateral.

122 *Receivables — Unsecured Surplus Property Sales Accounts*

Account 122 is a debit balance (asset) maintained to show the total of amounts due the United States on account of surplus property disposals, where such debts are not secured by collateral.

131 *Stores*

Account 131 is a debit balance (asset) account maintained to show the value of materials and supplies on hand, purchased with public funds or lawfully donated to the United States and available for issue.

141 *Surplus Property for Sale—At Owning Agency Sites*

Account 141 is a debit balance (asset) account maintained to show the net book value of surplus property declared and located at storage sites of owning agencies.

142 *Surplus Property for Sale—At W.A.A. Storage Centers*

Account 142 is the same as 141 except that it shows property located at W.A.A. storage sites.

144 *Surplus Property for Sale in Transit to Consignees*

Account 144 is a debit balance (asset) account maintained to show the net book value of surplus property shipped and in transit to consignees from owning agencies and W.A.A. storage centers.

146 *Surplus Property in Use*

Account 146 is a debit balance (asset) account maintained to show the net book value of surplus property in use by W.A.A.

211.02 **Liability and Accountability Accounts**

201 *Accounts Payable*

Account 201 is a credit balance (liability) account maintained to show the amount of unvouchered invoices representing assets acquired and accrued expenses payable from public vouchers.

222 *Receivables—Credit Balances*

Account 222 is a credit balance (liability) account maintained to show, for statement purposes, the credit balances existing in accounts receivable at the end of the month's operations.

281 *Accountability to Owning Agencies for Surplus Property Declared*

Account 281 is a credit balance (accountability) account maintained to show the cumulative accountability of the W.A.A for the reported cost of property declared surplus by owning agencies.

282 *Settlement with Owning Agencies*

Account 282 is a debit balance (accountability) account maintained to show the total of settlements made directly with owning agencies with respect to sales of surplus property.

283 *Non-Reimbursable Transfers of Surplus Property to other U. S. Government Agencies*

Account 283 is a debit balance (accountability) account maintained to show the declared value of cumulative transfers of surplus property to other Government agencies on a non-reimbursable basis.

291 *Donated Capital*

Account 291 is a credit balance (accountability) account maintained without regard to appropriations or funds to show the net value of assets lawfully donated to War Assets Administration and in the custody of the regional office.

211.03 **Operating Accounts**

301 *Sales (Excluding Scrap) Reimbursable*

Account 301 is a credit balance (nominal) account maintained to show the cumulative amount of sales of surplus property reimbursable to owning agencies.

302 *Sales (Excluding Scrap) Non-Reimbursable*

Account 302 is the same as 301 except that it shows sales of a non-reimbursable nature.

341 *Deduction for Disposal Expenses—Settlements with Owning Agencies*

Account 341 is a credit balance (nominal) account maintained to show amounts withheld from settlements with owning agencies to cover care, handling and disposal of surplus property in accordance with Section 30(B) of the Surplus Property Act of 1944.

351 *Cost of W.A.A. Sales*

Account 351 is a debit balance (nominal) account maintained to show the cumulative reported

cost of sales of surplus property inventory.

364 *Inventory Write-Offs-Revaluation of Surplus Property*

Account 364 is a debit balance (nominal) account maintained to show the cumulative reductions in inventory value of surplus property due to revaluation.

391 *Expense*

Account 391 is a debit balance (nominal) account maintained to show the total operating and administrative expenses incurred.

211.04 **Statistical Accounts**

401 *Retirement and Disability Funds*

Account 401 is a debit balance (statistical) account maintained to show the amount of retirement fund deductions and collections deposited into the Treasury.

451 *Retirement Contributions—Individual Earnings Record*

Account 451 is a credit balance (statistical) account maintained to show the amount of retirement fund deductions and collections for the current fiscal year which will be entered on the individual earnings record.

211.05 **Budgetary Accounts**

502 *Unobligated Allotments*

Account 502 is a credit balance (budgetary) account to show unobligated balances of allotments from appropriations.

503 *Unliquidated Obligations*

Account 503 is a credit balance (budgetary) account maintained to show the total unliquidated obligations under appropriations.

504 *Expended Allotments*

Account 504 is a credit balance (budgetary) account to show the total amount of expenditures as evidenced by vouchers and claims approved for payment from appropriations.

506 *Allotments from Washington Office*

Account 506 is a debit balance (budgetary) account maintained to show the amounts allotted to regional offices for administrative and operating expenses.

211.06 **Inter-Office Accounts**

601 *Receipts from Surplus Property Disposals Transferred to Washington Office*

Account 601 is a debit balance (inter-office) account maintained to show amounts derived from surplus property disposal which are transferred to Washington Office for accountability.

651 *Inter-Regional Office Control*

Account 651 which may have either a debit or credit balance, is maintained to show the transfer of transactions between Regional Offices, other than collections.

Pro Forma Entries

The following *pro forma* entries are illustrative of the disposal operations of the New York regional office:

(1) *Reported Cost of Surplus Property Declared by Owning Agencies and Located at Owning Agency Sites:*

141 — Surplus Property for Sale — At Owning Agency Sites

281—Accountability to Owning Agencies for Surplus Property Declared

(2) *Reported Cost of Surplus Property Shipped Under Consignment Agreements:*

144 — Surplus Property for Sale in Transit to Consignees

141 — Surplus Property for Sale — at Owning Agency Sites

(3) *Reported Cost of Non-Reimbursable Transfers of Surplus Property of other U. S. Government Agencies:*

283 — Non-Reimbursable Transfers of Surplus Property to Other U. S. Government Agencies

141 — Surplus Property for Sale — at Owning Agency Sites

(4) *Revaluation of Surplus Property Inventories:*

364—Inventory Write-Offs—Revaluation of Surplus Property Inventories

141 — Surplus Property for Sale — At Owning Agency Sites

(5) *Record of Sale of Surplus Property by W.A.A.:*

121 — Receivables — Secured Surplus Property Sales Accounts

or

122 — Receivables — Unsecured Surplus Property Sales Accounts

301—Sales (Excluding Scrap)—Reimbursable

or

302—Sales (Excluding Scrap) — Non-Reimbursable

and

351—Cost of W.A.A. Sales

141 — Surplus Property for Sale — At Owning Agency Sites

(6) *Amount of Appraised Value of Stores Donated or Transferred from Other Organizations in accordance with law:*

131—Stores

291—Donated Capital

(7) *Collections—Amount of Collections of Refunds to Appropriations Not Previously Billed:*

104 — Disbursing Officer's Cash — Undeposited Appropriation Repayments

391—Expense

(8) *Amount of Collections Applicable to Surplus Property Disposals:*

111 — Disbursing Officer's Cash—Receipts from Surplus Property Disposals

121 — Receivables — Secured Property Sales Accounts

(9) *Expenses Accrued — Amount of Expenses Accrued During the Period:*

391—Expense

201—Accounts Payable

(10) *Amount of Costs of Materials and Expenses Transferred From Other Regional Offices:*

131—Stores

391—Expense

651 — Inter-Regional Office Control

(11) *Semi-Monthly Transaction Recapitulation Submitted by Inventory Reports Branch:*

121—Receivables—Secured Surplus Property Sales Accounts

122—Receivables—Unsecured Surplus Property Sales Accounts

141—Surplus Property for Sale—at Owning Agency Sites

142—Surplus Property for Sale — at W.A.A. Storage Centers

144—Surplus Property for Sale in Transit to Consignees

146—Surplus Property for Sale in Use

283 — Non-Reimbursable Transfers of Surplus Property to Other U. S. Government Agencies

351—Cost of W.A.A. Sales

364 — Inventory Write-Offs-

Revaluation of Surplus Property

301 — Sales (Excluding Scrap) Reimbursable

302 — Sales (Excluding Scrap) Non-Reimbursable

281 — Accountability to Owning Agencies for Surplus Property Declared

(12) *To Record the Deposit of Receipts from Sales of Surplus Property in the Special Fund Receipt Account, and the Transfer of Accountability therefor to the Washington Office:*

601—Receipts from Surplus Property Disposals Transferred to Washington Office

111 — Disbursing Officer's Cash-Receipts from Surplus Property Disposals

(13) *Amounts of Credit Balances in Accounts Receivable at the End of the Month Transferred for Statement Purposes:*

122—Receivables—Unsecured Surplus Property Sales Accounts

222 — Receivables — Credit balances

(14) *Settlements with Owning Agencies for Proceeds Realized from Sale of Reimbursable Surplus Property, and Witholding of Care, Handling and Disposal Expenses in Accordance with Section 30 (B) of the Surplus Property Act of 1944:*

282—Settlement with Owning Agencies

111 — Disbursing Officer's Cash-Receipts from Surplus Property Disposals

341—Deduction for Disposal Expenses — Settlements with Owning Agencies

(15) *Monthly Summary of Allotment Ledger Totals — net monthly totals of transactions currently recorded in the various columns of allotment ledger accounts:*

(a) *Amounts Alloted by Washington:*

506—Allotments from Washington Office

502—Unobligated Allotments

(b) *Net monthly totals of transactions currently recorded in the various columns of allotment ledger accounts:*

502—Unobligated allotments

503—Unliquidated obligations

504—Expended Allotments

(16) *Amount of Retirement Funds Currently Deducted from Compensation of Employees during Calendar Year, as Reflected on Individual Earnings Records:*

105 — Disbursing Officer's Cash — Undeposited General Fund Receipts

451—Retirement Contributions—individual Earnings Records

(17) *Amount of Retirement Fund Deductions and Collections Deposited into the Treasury by Disbursing Officers:*

401—Retirement and Disability Funds

105 — Disbursing Officer's Cash—Undeposited General Fund Receipts

Conclusion

Although there is room for discussion regarding how well the War Assets Administration is accomplishing the objectives for which it was organized, it is apparent that the framework of its accounting system is sound and should serve as an example to the accounting profession of a satisfactory system for other organizations performing similar functions.

The Taxpert Rambles

By Lewis Gluick, C.P.A.

Perhaps, before you are finished reading this you will say this "Taxpert" is just plain delirious. But have we not all heard that August is the "silly season." According to some of our friends, we have only one season, and that's it. Anyhow let's take a stroll around Taxland. We will pass by the great monuments, the leading cases and legal lights, and look into the by-ways and alleys, even the public dump. Or to put it on a higher plane, we will emulate Proctor & Sullivan's organist, and "let our fingers wander idly over the noisy keys". If a little of what follows appears familiar, just forgive us; we are in our anecdotage.

In *The Journal of Accountancy* for July the esteemed J. K. Lasser did a Ripley. That is to say, he appears to have made an error—of omission. Even Homer nods. He cites a 1945 case by name only instead of giving chapter and verse. So for those of you who want to read a good case, look up *Wachtel Corp.* C.C.H. Dec. 14683M.

There are some clients who leave us speechless; and that, says Mrs. Gluick, is miraculous. One such incident happened over 25 years ago, and we are still glad that it wasn't our client, but merely one of the firm which employed us. She was proprietor of a dress shop, and incorporated. In due course, and routinely, a capital stock tax return was prepared for her, and mailed with an appropriate letter of transmittal. The usual form letter was not used, for the partner CPA was well aware that she needed words of one syllable. Two weeks later we showed up for the audit, and after about an hour she rummaged around in her desk and handed us a bunch of papers. "What do I do with these?" she queried. They were the 707's; and the due date was ten days past. Well, the boss finally got her off with a small fine for delinquent filing; but got no extra fee.

All we know about the *Glenshaw Glass* case is what we read at 474 CCH ¶7073M. But we'll hazard a guess that the tax angle of the increased compensation voted to officers, and disallowed by the Commissioner, was not properly considered in 1941 and 1942. The Tax Court held most of the increase unjustified.

It costs too many taxpayers plenty in legal fees and costs (not to mention added taxes, interest and penalties) to fight cases that need never have arisen. Sometimes the taxpayer is too penurious to pay a $100 legal fee, but later is compelled to pay $1,000. But too frequently it is sheer negligence. The directors just forget to notify their legal (and tax) counsel of meetings, or prospective action. Sometimes a dissenting director notes the omission and asks an adjournment till counsel can be summoned. Others vote him down. Then, years later, an I.R.A. finds the error. Boy, oh boy, does the lawyer (or accountant) get a hurry call then!

Readers are hereby given permission to quote this to *your* clients, provided this magazine is mentioned.

The case of *Robert S. Seese*, (CCH Dec. 15407) is the most humanly interesting one we have seen since we resumed Shoptalking. (In print, we mean; we never stopped talking it, given a ghost of a chance.) It seems this man was one of those rare indi-

Lewis Gluick, C.P.A., has been a member of our Society since 1924. He is now engaged in practice in Long Beach, California. He is best known as the Shoptalker, under which name he has been writing since 1928.

viduals who were really indispensable; when the Navy called him to active duty, the business went to pot; and as it was closely related to power lines, that hampered the war effort. His wife employed attorneys to get him released, which they did, and he attempted to deduct the costs as a business expense. The Commissioner denied that it was both "ordinary and necessary" and the Tax Court upheld the Commissioner. It was obviously most extraordinary despite the seeming necessity.

But the point which seems to have been entirely overlooked in the case, but which would have been decisive had we been the judge, is this. Seese had a commission in the Naval Reserve and performed training duty during 1938 to 1941. Knowledge of two things must be imputed to him. One, that he was going to be called to active duty any time after July first 1940; second, that he was the keyman of the business. Therefore, if he did not want to serve, he should have resigned in advance. Had he done so, the lawyer's fees would not have been necessary.

Incidentally, this Taxpert had a training cruise during the latter half of June, including a day in the submarine CATFISH.

We've had to listen to a lot of abuse (and so have you) about the inequities of the tax system, as though we were responsible for them. Revenue Agents have to have cast iron skins, for conscientiously attempting to enforce the laws they don't make. We constantly try to get objectors to write to their Representatives in Congress and Senators. In half the time they take to tell us orally they could write a letter that would command attention. Form letters don't; and shouldn't. But do they write? Even high-salaried executives with good stenos at hand won't bother. They just let off steam to the taxpert.

Right here in Long Beach there are probably more people dependent on pensions and annuities than any city its size. The injustice of the manner in which annuities are taxed is evident to all but some bureaucrats. But when we inquire "And what did Captain Bradley or Senator Knowland say when you wrote them?" there is an abrupt change of subject. The late and famous James Bryce said many decades ago that a nation got just the kind of government it deserves. Time and again, in speaking to large groups and small, we inquire how many know the value of the stamp on a package of 20 cigarettes. Answers range from 3¢ to 11¢. Fewer than one in ten know the right answer. Recently a large group laughed out loud when we gave the right answer, and urged them to demand that Congress play fair. Nothing but diamonds and alcohol are more worthy of being taxed, (yes, we smoke) but the cosumer ought to know what tax he is paying. " 'Taint funny M'Gee!" It's all very well to be good natured; and our American sense of humor is a great national asset. But when it laughs at such things, it is no wonder that our enemies put us down as fools, and our politicians balance budgets by increasing taxes instead of cutting costs.

Our pet peeve of longest duration is the part of the law that denies any tax benefit to the home owner who sells at a loss. We are entirely objective in our resentment, since we never have had such a loss, nor did any one near and dear to us. It is bad enough when a man has to pay the inflated prices now prevailing in order to get a roof over the heads of his family. But when the inevitable comes, too many of them are going to have a loss, and find insult added to injury in that no part of it is deductible against income. The Republicans can't blame it on the New Deal; and the New Deal couldn't blame it on Hoover. It was there *ab initio*. Its persistence is due to one factor. Home-owners are not organized. Pressure groups, numerically much smaller, get beneficial legislation of all kinds. The rugged individualist, who wants to own his own home, won't act to defend it taxwise. We could fill up a few more pages as to the why's and wherefore's

of this, and its economic and social by-products. The point we hoped we have made is: The writer has written to his representative and senator, and every time he gets a chance, urges home-owners to do so. How about helping him?

Rambling along, there are probably few accountants who have not had, one time or another, a client who goes somewhat nutty on the subject of increased sales volume, achieves it at a loss, and then complacently looks at the red figures and says "Well, anyhow, there's no income tax to pay." For an example of a non-quiescent client, see *7-UP For Worth, Inc.*, a Tax Court case reported at 463A CCH ¶5749. That company had huge volume and a loss in 1938, but "Although sales were 26,000 cases less the next year the company made a profit". A delightful bit of testimony is also found. "It's a nickel business and people can find a nickel in '32 as well as '45". D. R. Bonner, a C.P.A., seems to have done a good job with the evidence.

The refugee cases, 474 CCH ¶7471M and 7454M, have more human interest than legal importance. The trials and tribulations of some of our newest citizens are calculated to arouse pity. We deem the Tax Court was legally correct in both cases, but wonder how the taxpayer feels about the *justice* they expected to get from a democratic government.

If we ever get to Providence, R. I., we hope our erstwhile shipmate Sid Kane will take us to the Turk's Head Club for lunch. Why? Read 471 USTC ¶9243.

Some purists think that "set-up" is an *infra-dig* word. They are not supported by the U. S. Court for the Eastern District of Wisconsin. In describing the form of organization used by the Milwaukee Association of Commerce, the Court used "set-up". (474 CCH *page* 12,503). Mr. J. M. Lambie, whom *The Journal of Accountancy* calls a "Readability Expert" (July 1947, page 40) will like that.

And that, readers, concludes our stroll through Taxland. "Had enough?"

New York State Tax Clinic

Conducted by Benjamin Harrow, C.P.A.

New York Unemployment Insurance Law—'Merit' Refunds

The standard rate of tax on covered compensation is 2.7%. In 1946 for the first time employers received a credit against such payments. The credit represented a surplus in the unemployment insurance fund, a portion of which was distributed among qualified employers. For 1947 a further distribution of a portion of the surplus has been authorized. Employers who will qualify for such a credit are those who were liable for contributions during seventeen quarters ending on March 31, 1947, a period of four and one-quarter years. There is a further requirement that such employers must have filed their contribution reports due for such quarterly periods and paid their contributions by September 30, 1947.

The determination of the amount of the credit is based upon a benefit factor, benefits paid to employees during a three year period; a so-called quarterly factor, that is the measure of decreases in the employer's payroll during this three year period; and the age factor that is the number of years the employer has been liable for contributions under the law. Each factor is rated and the sum of the factors is used as a basis of classification of each employer into one of six classes. Each class receives for distribution a weighted portion of the surplus. The surplus is the amount by which the insurance fund on September 30 exceeds 3½ times the total taxes payable during the year 1946 but not in excess of 60% of such taxes. If the amount of the surplus should be less than 10% of total contributions payable no distribution will be made.

The credit is to be applied against contributions payable during four quarters beginning on October 1st. The credit therefore can first be used to reduce the payment due in January, 1948. A cash basis taxpayer will not report the refund as income for federal income tax purposes until 1948. On the accrual basis the refund will accrue as income on October 31, 1947, November 30, 1947, and December 31, 1947, to the extent that the credit covers the liability of 2.7% of all compensation payable for the months of October, November and December, 1947, respectively.

Benjamin Harrow, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University. Mr. Harrow taught accounting at The College of the City of New York from 1919 to 1924. He has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is presently serving on the Society's Committees on Federal Taxation, State Taxation, and Cooperation with the State Education Department and Its Agencies. Mr. Harrow is engaged in general practice as a certified public accountant in his own office in New York City.

United Parcel Service of N. Y., Inc. v. Joseph
(App. Div., 1st Dept., May 2, 1947)

This was a case involving tax liability under the New York City Utility Tax Law. The term "utility" included persons under the jurisdiction of the Department of Public Service. *United Parcels,* a contract motor carrier, was subject to supervision of the Department of Public Service to the extent of a small part of its income (7%) which was derived from transportation outside of New York City. The Comptroller sought a tax on its New York

City income because jurisdiction under the Department of Public Service gave it a classification of a utility, even though the out of city income was non-taxable.

The court held that the legislature intended to subject to city utility taxation only real utilities doing business as such within the City of New York and that United Parcels was not a utility with respect to its delivery operations in New York City. As a non-utility it was subject only to the New York City Gross receipts tax which of course was much less than the Utility tax. As the court put it, "where a literal construction of a statute will produce an unjust result the dictates of propriety and justice will be used as guides to the true legislative intent." We think the case was correctly decided.

Toward a Simplified Income Tax Return

In 1944, when the franchise tax on business corporations was revised, some thought was given to the adoption of a simplified form for the income tax return. One suggestion made was to have the taxpayer report to the state the actual net income reported to the federal government and compute the tax on this amount at the state rates. The objection raised was that under state law net income is not the same as under federal law. To cite one or two examples, New York includes in net income interest on bonds of other states while such interest is exempt under federal law. New York allows no deduction for state income taxes paid whereas such taxes are deductible federally. The state of Michigan recently considered a state income tax law computing its tax on a percentage of the federal net income after the deduction of State exemptions. Rhode Island recently considered a law computing the state tax as a percentage of the federal tax. Apparently a simplified tax for New York could be worked out.

Deduction for Medical Expenses

Husband and wife file separate income tax returns, the husband taking the entire personal exemption as well as the credit for one dependent. What is the maximum deduction for medical expenses that the husband may take in arriving at taxable net income?

Section 360 (15) of the law provides that "an individual who files a separate return may deduct only such expenses as exceed five per cent of his net income . . . and the maximum deduction for any taxable year shall not be in excess of fifteen hundred dollars in the case of a head of a family, and not in excess of $750. in the case of all other such individuals."

In a series of questions and answers released by the Tax Commission on March 18, 1943, the reply to a similar question was $750. The payments must actually have been made by the husband. The medical expense deduction may include expenses for the dependent for whom a dependency credit is allowable. A non-resident may not take the deduction for medical expenses since these are not considered connected with taxable income arising from sources within the state.

Resident and Non-Resident Estates

Estates and trusts are taxable entities. The net income is generally computed in the same manner and on the same basis as the net income of an individual. The extent to which such income is taxed depends upon the status of the estate or trust as a resident or non-resident estate or trust.

If a decedent at the time of his death was domiciled within the state, the estate is a resident estate. If such a decedent created a trust under a will, the trust is a resident trust. Likewise if a trust is created by a person who at the time was domiciled within the state, the trust is a resident trust.

Where a trust is created by a person not at the time domiciled within the state, the trust is a non-resident trust.

The residence of the fiduciary does not in any sense affect the classification of estates and trusts as resident or non-resident. This permits the naming of New York fiduciaries without affecting their tax liabilities.

The resident estate or trust is taxable on all of its income from all sources while the income of a non-resident trust is taxable only to the extent that it is received from property owned within the state, or from business carried on within the state, the same as non-resident partnerships. These rules are, of course, subject to the further rules with respect to the distribution of income to beneficiaries.

Under sec. 365 (1) income taxable to the estate or trust may consist in part of the following:

(a) Income received by the estate of deceased persons during the period of administration.

(b) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests.

(c) Income held for future distributions.

(d) Income used to pay life insurance premiums.

(e) Income which may be distributed in the discretion of fiduciaries.

If during the period of administration income is properly paid or credited to a beneficiary such income is taxable to the beneficiary and the amount is deductible in computing the net income of the estate. For years beginning on and after January 1, 1942, in the case of income which may be distributed in the discretion of the fiduciary, the beneficiary likewise is taxable on income properly paid or credited to him, and such income is deducted in computing net income of the estate or trust.

It should be noted that the gain or loss on the sale of property of a revocable trust is taxable to the trust entity and not to the grantor, the law in this respect differing from the federal law. All other income of a revocable trust is taxable to the beneficiary if distributed. Likewise, where an individual creâtes a trust partly revocable and partly irrevocable, the entire income is taxable to the beneficiaries to the extent distributable and no part to the creator of the trust. In this situation, too, the federal rule is not followed.

Resident and Non-Resident Beneficiaries

A resident beneficiary is taxable on his income from all sources and this would include his distributive share of net income of any estate or trust whether resident or non-resident, and whether the income is from sources within or without the state. Article 245 of the Regulations provides that income of the estate actually distributed to beneficiaries during the period of administration constitutes taxable income to them, even though the amounts distributed exceed the net income of the estate.

Stock dividends distributed to beneficiaries are not taxable as income until sold by them, and the basis for determining gain or loss is the fair market value of the shares at the date of distribution. This method of determining the basis is radically different from the usual basis required in other sections of the law.

The non-resident beneficiary would be taxable only on such part of his income from the estate or trust as arises from sources within the state. This would not include annuities, interest on bank deposits, bonds or notes or dividends, unless such income is part of a business carried on within the state.

The classification of estates and trusts and beneficiaries as resident or non-resident lends itself to double taxation. A resident of Virginia who was the beneficiary of a discretionary resident trust of New York was held to be taxable on the income of such trust in Virginia, even though the income was also taxable in New York. This situation came before the Supreme

Court of the United States in 1938. Since 1942 under New York law such income, if properly paid or credited to the beneficiary during the year, would be a deduction in arriving at the net income of the estate and so would not be taxed in New York.

Income Accrued at Decedent's Death

Article 542 provides two methods of reporting a decedent's income for the portion of decedent's taxable year prior to the date of his death. The executor may accrue all income up to the date of death even though the decedent customarily reported his income on the cash basis. This was the former federal rule.

The other method corresponds to the present federal rule. Such income need not be reported in the decedent's final return if the executor agrees to report such income when actually received by the estate. Likewise any other taxpayer who acquires the right to receive such income as a legatee may agree to report such income for taxation when received by him. If an executor or other taxpayer has the right to receive this income he must agree to include as income the fair market value of such right plus the amount by which any consideration paid for the transfer exceeds the fair market value. The income has the same character in the hands of the executor or other taxpayer that it would have had in the hands of the decedent. Under the second procedure the Tax Commission requires the filing of a bond not in excess of double the amount of tax which would have been due if this accrued income had been included in the decedent's final return. Where two returns are filed *simultaneously* (1) for the *decedent* prior to death and (2) for the *estate* for the balance of the calendar year, then the second return may include the accrued income without the need for the agreement or the bond.

Deduction for Franchise Tax

Deputy Commissioner Burton recently clarified the question of the deductibility of the franchise tax where a corporation on a fiscal year ending March 31, 1947, ceases operations on that day and dissolves on May 31, 1947. For the fiscal year ending March 31, 1947, the deduction for franchise tax is the tax due on the return filed for the previous fiscal year, that is the year ending March 31, 1946. Since the corporation was still exercising its charter after March 31, 1947, a final franchise tax report is due for the period from April 1, 1947, to May 31, 1947, the date of dissolution. On this report the allowable franchise tax deduction will be the franchise tax shown to be due on the report for the fiscal year ending March 31, 1947, plus the tax computed on the final report. Of course if the corporation ceased operation on March 31, 1947, and therefore had no income for the period of two months preceding the dissolution it derives no benefit from the franchise tax deduction based on the final year of its operations. This illustrates one of the inequities in the method employed under our law for the franchise tax deduction. (See our discussion in the May issue of the New York State Tax Clinic.)

Salary Elimination Basis—Franchise Tax

One of the alternative bases for measuring the franchise tax under Article 9A is the so-called salary elimination basis. Under this basis the tax is computed on 30% of the entire net income plus salaries and other compensation paid to the taxpayer's elected or appointed officers and to every stockholder owning in excess of five percent of its issued capital stock minus $15,000 (formerly $5,000) and any net loss for the reported year.

To determine the stockholders to be included in this computation the total number of shares of all classes of out-

standing stock is the basis, and not the value or character of the stock.

The regulations (Art. 320) provide that an elected or appointed officer includes the chairman, president, vice-president, secretary, assistant secretary, treasurer, assistant treasurer, comptroller and also any other officer, irrespective of his title who is charged with and performs any of the regular functions of such officer. A director as such is not an elected or appointed officer, but if an officer is also a director, director's fees are included in his compensation. Giving an employee an honorary title of officer as that term is defined under this provision of the law may be costly taxwise under this basis for determining the franchise tax.

It would appear that this basis was meant to eliminate the question of whether a salary is excessive. However, the tax commission does question excessive salaries where the net income basis would yield a greater tax by disallowing a portion of the salaries.

Estate of Elizabeth Billings

(Surrogate's Court, New York County, April 8, 1947.)

This is an interesting estate tax case involving the computation of the tax on a non-resident's estate. The particular taxpayer was domiciled in Vermont but left some real and tangible personal property in New York. Sec. 249p provides that the tax shall first be computed upon the entire net estate that would have been payable if the taxpayer had been a resident of this state. The actual tax due is determined by taking the ratio of the value of the gross estate in New York to the value of the gross estate determined for the purpose of computing the tentative tax. This ratio is then applied to the tentative tax to determine the tax due.

In the case before the Surrogate the decedent had left real estate appraised at $447,450. It was subject to a mortgage of a like amount for which the estate was not liable. The executor argued that in applying the formula the gross estate should include the property at zero, the actual equity in the property. The effect of such treatment was to reduce the taxable percentage from about 37% to about 7%. This treatment was upheld by the Surrogate. To do otherwise said the Court would tax the property of a non-resident in this state at a higher valuation than in the case of a resident, an inequality never intended and probably unconstitutional. We think the decision is correct. The United States Supreme Court[1] recently refused to permit a taxpayer to treat a sale of property as a sale only of the equity. In that case too the property was inherited and subject to a mortgage on which the owner was not liable. In the *Crane* case the taxpayer had had the benefit of deductions for depreciation for several years on the value of the property undiminished by the mortgage. The court held that the basis for determining the gain was the gross value of the property adjusted for depreciation allowed and the selling price included the amount of the mortgage. Of course both cases involved different taxes and different situations and, in our opinion, both were correctly decided.

Estate of John Edward Mullins

(Surrogate's Court, Kings County, April 10, 1947.)

This is another estate tax case involving two interesting points. The first one raised the question of the decedent's domicile. He had a residence in France where he had actually lived for a little over eight years. On the evidence the Court decided that the intent to establish his residence in France as his domicile had not been proved. As the Court put it satisfactory evidence was lacking of an intent to abandon his domicile of origin in New York.

While the terms "residence" and

---

(1) *Beulah B. Crane v. Commissioner*, 67 S. Ct. 1047.

"domicile" are often loosely used interchangeably there is an important difference. An individual may have more than one residence but only one domicile. To change a domicile there must be an intent to establish a new domicile plus an actual presence in the new domicile. Jurisdiction to tax under the estate tax law is based upon domicile. That having been determined to be New York this estate was taxable on all the property of the decedent wherever situated.

The second point in this case involved the *Helvering* v. *Hallock* decision, subjecting to tax transfers under which the decedent retains a possibility of a reverter and also the fact that it is the practice to construe the New York law in conformity with the Federal law.

This decedent had created a trust in 1936 in which there was a possible reversion if the life income beneficiary had predeceased him. The decedent died in 1937 at which time such a reversion did not make the transfer taxable under *Helvering* v. *St. Louis Union Trust Co.* (296 U.S. 39) and *Becker* v. *St. Louis Union Trust Co.* (296 U.S. 48). The *Hallock* case did not overrule these cases until 1940. The appraiser's report was not filed until 1944 and the State Tax Commission sought to apply the *Hallock* decision which was the law at that time, even though the federal tax authorities had not included the transfer as a taxable one.

The Surrogate decided that the transfer should not be included in the gross estate, basing his decision upon a doctrine of uniformity of administration of the tax law. The Surrogate cites a number of cases holding that "it is the established legislative policy of the State to conform the estate tax law to the provisions of the Federal estate tax law." This is startling doctrine for states zealous of their prerogatives as sovereign powers. Therefore it is not surprising to read in the opinion the statement of the Surrogate that "the regulations of the Bureau of Internal Revenue do not govern the New York State Tax Commission nor are they necessarily followed or applied by the State of New York." The Court would have us infer merely that great weight is given the construction of corresponding provisions adopted in the Federal Courts.

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

The statements appearing in the Professional Comment department of the June, 1947, *New York Certified Public Accountant* lead me to set down a few suggestions that I would like to make after having spent a number of years in teaching accounting at the collegiate level.

In the first place I am heartily in agreement with respect to the need for more and better case material in accounting instruction. While this need exists in all fields of accounting, it is perhaps most acute in the field of auditing.

However, teachers cannot by themselves overcome this deficiency for the following reasons:

(1) Such material must be drawn from actual business experience and few college teachers can afford the time required to obtain both the advanced degrees now a prerequisite to most full time university positions and an extensive practical experience. It is true that many accounting teachers have had some practical experience, but those whose primary occupation is teaching have rarely had this experience at a level where other than routine problems of accounting are met. Teachers with adequate practical experience, on the other hand, usually devote their efforts principally to professional practice and have little to do with preparation of the instructional materials used in teaching.

(2) Even a man with the best experience can lose contact with practice when he enters teaching at a responsible level and on a full time basis. I could easily cite examples of such men who are still thinking and teaching in terms of experience which ended 10 or more years ago.

It appears to me that the accounting profession can do much to narrow this gap between teaching and practice. Every firm has in its files and in the experience of its staff a large store of material of the highest value in training students, but access to this material is generally denied to academic men and too often even to younger members of the firm's own staff. There are, of course, good reasons why such material is restricted and any use of it by outsiders would have to be conditional upon protection of confidential relationships with clients. However, it seems that means could be worked out to overcome such difficulties. A similar confidential relationship exists between doctor and patient, but medical instruction gains much from its extensive use of case material and there appears to be no reason why practice could not be similarly drawn upon for instructional material in accounting.

A few specific suggestions may point the way in which this could be carried out.

Case and problem material can be drawn from working paper files without objection if care is taken to remove names, specific figures, and other marks of identification. The same situation which faced the practical accountant can be put before the student without telling him from whose business it was drawn. The competent teacher is well aware of the necessity for judicious use of such sources of material and can be relied upon to use it properly. However, the professional firm could assure itself on this point by getting better acquainted with more members of the teaching profession.

Outside teachers might be included with advantage in the professional firm's training courses given for its staff. The writer's experience with

some such courses has shown that the firm could sometimes gain as much or more than it gives from the assistance that a skilled teacher would be able to give in organizing a good staff training program.

Attention could be given to publication of case studies presenting experience drawn from the profession. Such material is reasonably abundant in other fields of accounting, but notably lacking in the field of auditing. National and state society journals might well encourage contribution of such case studies from members of the profession. The profession might also provide assistance to academic men and graduate students, many of whom would be keenly interested in the development of such material for publication.

Doubtless there are still other approaches to the problem, but whatever they may be it seems essential that the experience of the profession be made freely available to teachers of accounting if the colleges are to supply better trained men.

Very truly yours,

WALTER B. MCFARLAND

Bronxville, N. Y.
June 14, 1947.

To the Editor of *The New York Certified Public Accountant:*

I have recently had occasion to discuss at great length, with officials of the Bureau of Internal Revenue, the sale of a business as a going concern and, accordingly, have read Mr. Gruneberg's article on the same subject in the June, 1947, issue of *The New York Certified Public Accountant* with great interest.

In looking over the article, however, I observed that Mr. Gruneberg failed to comment on the tax results when a covenant not to compete for a number of years is entered into by the owners of an unincorporated business.

This sort of restriction appears to be quite common in such sales. The Bureau's position is that any payment by a purchaser allocable to a covenant not to compete, must be treated as ordinary income by the seller of the business, and so reported in the year of receipt. The purchaser of the business may write off any expense allocable to the covenant over the terms of years which the covenant runs.

The valuation of good will for tax purposes has always been a complicated problem in connection with the sale of any business. Where a covenant not to compete is included in a transaction involving good will, and where the *Williams* case applies, elements of both ordinary income and capital gain are present.

Very truly yours,

KERMIT J. BERYLSON

New York, New York
June 13, 1947.

Reply by MR. GRUNEBERG:

The letter of Mr. Kermit J. Berylson raises interesting questions with respect to the treatment of the amount received for a non-competition agreement and with regard to ordinary income and capital gain derived from a single transaction involving good will and such an agreement.

(1) The sales price for a business as a going concern is the consideration for the net assets of the business plus good will. However, any consideration paid for a covenant restricting the activities of the seller so that he may not compete in a specified line of business for a certain period of time and within a specified territorial area, is not a part of the purchase price. This is shown very clearly in *Beal's Estate* (C.C.A.-2,1936,82F (2d) 268). Besides, it is apparent that such agreement is not, and cannot be, an asset of the business (*Salvage*, C.C.A.-2,1935, 76F (2d) 112). Rather is the agreement a promise not to exercise the privilege of engaging in a specific line of business. "Payment for (such) promise is income, not proceeds re-

ceived on disposal of a capital asset" (*Beal's Estate*, supra). Therefore, the income from such agreement is ordinary income which is to be amortized over the life of the agreement (*Carboloy Co., Inc.*, Memo T.C., 1943, Docket Nos. 101345 and 101920).

(2) Thus, whether one will follow the *Williams* case or the principles advanced by this writer in the June issue of *The New York Certified Public Accountant*, a sale of a business as a going concern connected with a non-competition agreement will result in ordinary income (or loss) and capital gain (or loss). In such case, every taxpayer is interested in reducing his tax liability by over—or undervaluing the different items sold. Such a manipulation is recognized in *Fraser* v. *Nauts*, Distr. Ct., N. D. Ohio, 1925, 8F (2d) 106: "H. (the deceased taxpayer) had a clear right to fix a value on each item of property he had to sell, whether his choice was to establish a depreciated or exorbitant figure . . . He was justified in law to place upon his merchandise a low or inadequate price as an inducement to obtain a market for his less salable good will . . ." This surprising decision was never formally repudiated; rather, it was later cited with approval (e.g., in *J. M. Walsh*, 18 B.T.A. 571,577). On the other hand, the Circuit Court of Appeals (*Klausner*, C.C.A.-2, 1928, 25F (2d) 608) takes a cautious attitude in this matter and states that putting an inflated price on stock and undervalued prices on other assets may "perhaps . . . not be subject to successful attack by the taxing officials". Anyway, this writer is of the opinion that the way of reducing taxes by fixing more or less arbitrary values upon the different items sold, should always be done in good faith. However, the measure of discretion, even within these limits, will show substantial tax savings.

Very truly yours,

CURT GRUNEBERG

New York, New York
June 21, 1947.

To the Editor of *The New York Certified Public Accountant:*

On page 362 of the June, 1947, issue of *The New York Certified Public Accountant* appears the following statement:

> "Old standard cost systems will be dusted off, refurbished and placed again in active operation. New standard cost systems will spring up like dandelions in May. The old-fashioned, so-called actual cost systems will in the course of time be very largely superseded by standard costs. The new standard cost systems will be systems based on real cost standards, developed with care and furnishing a sound basis for cost control. Many so-called standard cost systems in operation before the war were little better than applications of an estimating procedure, and frequently the estimates were not too carefully made. They represented progress in the right direction but were far from the finished product which is not to be expected."

I have never been very much impressed by standard costs. I realize that perhaps they have their place, but I agree with the author that "many so-called standard cost systems before the war were little better than applications of an estimating procedure and frequently the estimates were not too carefully made". The author makes the statement that "the new standard cost systems will be systems based on real cost standards, developed with care and furnishing a sound basis for cost control". I would like to know whether, in the author's opinion, it would not be necessary, in order to get standard costs "based on real cost standards" to use the "old-fashioned so-called 'actual cost systems'." In other words, I am wondering how to get standard costs that can be called "real" without going through the process of getting actual costs. If there is some way of doing this I certainly would be interested in knowing about it. I am wondering if Prof. Taggart could give me some information along this line.

Yours very truly,

L. C. ANDERSEN

Schenectady, New York
June 13, 1947.

Reply by DEAN TAGGART:

The kind of cost standards to which I had reference are not arrived at by a study of past actual costs. Instead, they are derived from engineering studies of specifications and operations. Furthermore, standard costs are accompanied by standardization of products and operating methods. Nothing is gained by adopting paper standards, however carefully established, if no steps are taken to make them live.

The procedure requires an analysis of the product with respect to its physical characteristics and material content and time and motion studies of the labor and machine operations required. Waste factors may be derived in part from past experience. It is to be noted, however, that the establishment of an adequate standard cost system may involve a break with the past of such a character that past records of material usage and operation time may be of no importance. Material specifications may be changed in order to reduce waste or facilitate processing, and labor and machine operations may be substantially altered as a result of the time and motion studies required for setting the standards.

Past cost records will be of some assistance in establishing burden rates, but they are by no means controlling. A thoroughgoing standard cost installation requires the same attention to service operations as to production.

Very truly yours,

H. F. TAGGART

Ann Arbor, Michigan
July 2, 1947,

To the Editor of *The New York Certified Public Accountant:*

I have read Mr. Milton C. Charles' article on "Tax Accounting for Laundry and Linen Supply Companies" in your June, 1947, issue of *The New York Certified Public Accountant.*

I differ with Mr. Charles' opinion on the question of writing off goodwill for tax purposes, that is, the purchase of customers' routes. It has been my experience that where a detailed specific list of customers has been purchased and each individual customer's weekly or monthly service amount is shown, the purchase price can be written off as these customers are lost and taken as a capital deduction for tax purposes; and, I have been upheld by the Bureau of Internal Revenue on this. Intangibles do not differ from tangibles when proper accounting procedure and identification of such accounts are maintained.

Yours very truly,

HERMAN NICHOLS

New York, New York
June 16, 1947.

Reply by MR. CHARLES:

In reply to the letter dated June 16, 1947, received from Mr. Herman Nichols, I wish to set forth the following:

It has been said that goodwill "is a thing very easy to describe but very difficult to define." From a review of the cases in which the element of goodwill was an issue, it appears that a clear and concise definition of the term has eluded all legal authorities.

In *Metropolitan Bank v. St. Louis Dispatch Company*, 149 U.S. 436, the Court stated:

> "Goodwill is not necessarily confined to a name. It may as well attach to a particular location where the business is transacted or *to a list of customers*, (italics added), or to other elements of value in the business as a going concern."

In the case of *Borden's Estate*, 95 Misc. 443, 159 N. Y. Supplement 436, the Court stated:

> "The definitions of 'goodwill' are many and irregular, and I prefer to define it for myself as that economic value recognized in law and denoting the chance of future profit while carrying on an established business of repute in public consideration."

In Brown's Will, 242 N.Y. 1, 150 N.E. 581, 44 A.L.R. 510 (1926), the Court stated:

> "Men will pay for any privilege that gives a reasonable expectancy of preference in the race of competition. *Cf. Walton Water Company* v. *Village of Walton*, 143 N. E. 786, 238 N. Y. Such expectancy may come from success in place or name or otherwise to a business that has won the favor of its customers. It is then known as goodwill."

It is the writer's opinion that where a route or a number of routes of a linen supply business, or any similar business for that matter, are purchased, the vendee is acquiring the goodwill of a business. He is not purchasing a particular customer's business, but rather the business or goodwill of the vendor.

It is seldom that the value of goodwill can be accurately determined by the use of any one measure of value. Book values obviously do not control. It is, therefore, ordinarily necessary to approach the problem of valuation by the use of a number of the commonly accepted yardsticks of value and, on the basis of these measures of value, to form a reasoned judgment as to the value. The yardstick most commonly used in the linen supply business is the setting of a fixed value for each hundred dollars per week of collections.

I again wish to state that in my opinion when a linen route is purchased, it is not so much the purchase of the individual customers, as it is the acquisition of a going business. The fact that a certain value is placed on each individual customer is merely the yardstick which the industry uses as a means of determining the goodwill of the business.

As pointed out in the *Metropolitan Bank* case, "Goodwill * * * may as well attach * * * to a list of customers."

Since no loss may be claimed with respect to goodwill until the business to which the goodwill is attached is sold or otherwise disposed of at a loss, it is the writer's opinion that the loss of a customer would not entitle the vendor to claim as a deduction a value assigned to the particular customer.

I feel that the loss of any particular customer is only part of the overall picture to be considered. The amount paid for the business or route represents the value of the goodwill of the business or route as a going concern, and not to any particular part thereof.

However, since Mr. Nichols states that he has been upheld by the Bureau of Internal Revenue in this type of deduction, I feel that it would be of considerable advantage to the membership of the New York State Society of Certified Public Accountants if he would elaborate somewhat on his statement and give more detailed data.

Very truly yours,

MILTON C. CHARLES

New York, N. Y.
July 10, 1947,

CORRECTION

In the article entitled, "Fund Accounting for Voluntary Hospitals", by Mr. Simon Loeb, which appeared in the July, 1947 issue, a typographical error remained uncorrected in the final copy. The corrected text on page 427, right column, line 8 should read as follows:

> "A complementary journal entry is required to restore the balancing feature of the General Fund account and the Plant Capital account, via a credit to the General Fund surplus account and a debit to the Plant Capital account."

OFFICIAL DECISIONS *and* RELEASES

SECURITIES AND EXCHANGE COMMISSION

Philadelphia

SECURITIES ACT OF 1933
Release No. 3234

ACCOUNTING SERIES
Release No. 62

The Securities and Exchange Commission today announced the issuance of an opinion in its Accounting Series indicating the circumstances under which independent public accountants may properly express an opinion, and the form of such opinion, with respect to summary earnings tables to be included in registration statements filed under the Securities Act of 1933. The opinion, prepared by Earle C. King, Chief Accountant, follows:

"Inquiry has been made from time to time as to the circumstances under which independent accountants may properly express an opinion with respect to a summary earnings table to be included in a registration statement filed under the Securities Act of 1933.

"As its name implies, the summary earnings table is a highly condensed form of profit and loss statement designed to apprise the investor, in a convenient fashion, of the financial results of the operation of the business for a reasonable period.[1] Such tables have been of particular importance in recent years as a means of comparing the operation of the business in the pre-war, war, and post-war periods.[2] To accomplish this purpose the tables usually embrace a suitable span of years and set forth in comparative form for each year appropriate information with respect to the major income and expense categories applicable to the business.[3] Since such summaries are presented in the light of the circumstances existing at the date of registration it is often necessary and appropriate to recast the figures originally reported for earlier years to give effect to transactions or adjustments which were recorded in the more recent years but which are clearly applicable to the operations of the earlier years included in the summary.

"In order that investors may make proper use of the summary earnings table and to prevent the possibility of misleading inferences, certain explanatory data are usually necessary. If, for example, the reported earnings reflect the results of unusual conditions, or in certain years include significant nonrecurring items of income or expenses, an appropriate disclosure of such conditions or items is made either in the summary or in footnotes thereto. Where applicable, there are also shown in an appropriate manner the anticipated annual fixed interest charges and preferred dividend requirements at the date of registration, after giving effect to any proposed changes in the nature and amount of outstanding indebtedness or securities. It is not, however, necessary to include footnotes covering all of the information required by Regulation S-X with respect to the more detailed financial statements unless, in a particular case, certain information is of such special significance in appraising the summary that its omission would be likely to give rise to misleading inferences.

"Summary earnings tables included in registration statements are not required by the Commission's rules to be certified by independent public or independent certified public accountants. It is, nevertheless, common practice to introduce the summary with language indicating that it has been 'reviewed' by independent accountants.

"This use of an accountant's name in connection with a summary earnings table is designed and tends to give added authority to the material presented. It is important, therefore, to consider the extent of the examination to be made by the accountant in such cases and the extent of the responsibility which he as an expert accountant can properly assume.

[1] Ordinarily, the summary earnings table will reflect the operations of the registrant, or of the registrant and its subsidiaries, during the period covered. However, under special circumstances, as where the registrant has succeeded to the business of one or more predecessors, it may be necessary for the summary to be specially constructed so as to reflect as far as possible for the period covered the earnings applicable to the enterprise now represented by the registrant. Where, for example, a predecessor operated as a partnership it is ordinarily necessary to indicate in an appropriate manner the adjustments required to place the partnership income on a corporate basis. In other unusual cases there may have been such violent and radical changes in the business of the registrant that a long summary of past earnings might be of very little or no value and might well be misleading. In several such cases, the registrant has been requested either to delete the summary entirely or to furnish only a brief statement of the overall, aggregate results, without a breakdown as between the several years. In any case, where special and unusual circumstances exist, a decision as to the content of the summary and as to whether or not a summary should be furnished at all can only be reached after careful appraisal of the particular facts of each case.

[2] For a discussion by the Commission on the use of earnings statements in evaluating the future prospects of a company, see Part VI of Accounting Series Release No. 53, November 16, 1945.

[3] In the case of public utility companies, most of the summaries have been given in detail comparable to the formal income statements.

"Financial statements filed for the registrant and its subsidiaries have been recognized by this Commission and by public accountants generally as representations of management upon whom rests the primary responsibility for their propriety and accuracy. Thus, *In the Matter of Interstate Hosiery Mills, Inc.*, the Commission stated:

" 'The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable.' [4]

"Along the same lines, the Committee on Auditing Procedure of the American Institute of Accountants has said:

" 'Management itself has the direct responsibility for the maintenance of an adequate and effective system of accounts, for the proper recording of transactions in the books of account, and for the safeguarding of the assets of a concern. It is also charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations. . . .

" 'It should be borne in mind that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the client. It is upon all these representations that the independent certified public accountant renders his opinion. If he considers explanations essential or desirable, and they have not been made in the financial statements, it will be necessary for him to make such explanations in a separate paragraph of his report.' [5]

"It is an obvious corollary of this principle that, as was also said in the Interstate Hosiery opinion:

" 'Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting.' [6]

This same principle has been stated in more detail by the Institute's Committee on Auditing Procedure as follows:

" 'The function of the independent certified public accountant is to examine a concern's accounting records and supporting data, in certain matters to obtain outside confirmations, and to require and consider supplementary explanations and information from the management and employees, to the extent necessary to enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and the results of periodic operations. Generally speaking, his function is limited to reporting upon situations arising out of business transactions that have taken place in the past. In no sense is he an insurer or guarantor. In offering his opinion, the independent certified public accountant assumes heavy responsibilities. He must be skilled in his professional work and must have made a reasonable examination of the accounts in order to warrant his expression of an opinion. He must state his opinion clearly and unequivocally.' [7]

"In my opinion, it follows from these statements of principle that summary earnings tables, as a species of financial statements, are primarily representations of management and that the proper function of the independent accountant with respect to them is necessarily limited to an expression of his expert and professional opinion.

"It has long been recognized, however, that an independent accountant in his capacity as such cannot properly undertake to express an opinion as to representations in financial statements except on the basis of an adequate examination conducted with professional skill and acumen.[8] Indeed, the Rules of Professional Conduct of the American Institute of Accountants make it an 'act discreditable to the profession' if the auditor in expressing his opinion 'fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion'; or if he 'fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.' [9] This general obligation may be summarized in this way—that an independent accountant is not in a position to express an opinion except on the basis of an examination made in accordance with generally accepted auditing standards applicable in the circumstances and

[4] 4 S.E.C. 706, 721.

[5] Statement No. 1, pp. 4, 10, October, 1939; see also Statements Nos. 4 (March, 1941) and 22 (May, 1945). To the same effect, Bulletin No. 1 issued by the Committee on Accounting Procedure of the Institute in September, 1939 states: "At the base of all committee pronouncements is the further understanding that the accounts of a company are primarily the responsibility of its officers."

[6] The value of this check is obviously lost if the accountant is not fully independent. See Accounting Series Releases Nos. 2, 22, 28, 37, 44, and 47 and cases therein.

[7] Statement No. 1, p. 3. See also editorial "Whose balance sheet is it?" 69 Journal of Accountancy 338 (1940).

[8] Cf. *In the Matter of Red Bank Oil Company* (Securities Act Release No. 3110, January 4, 1946).

[9] Rule 5 par. (d) and (e). Similar rules have been adopted by many state societies of certified public accountants.

including all procedures which he deemed necessary in view of the circumstances of the particular case.[10] Clearly, the mere summarization of detailed financial data prepared or presented by others does not involve most of the fundamental accounting and auditing skills customarily and properly relied upon as giving additional weight to financial statements certified by independent public accountants and adds nothing to the reliability of the underlying information.

"In view of the foregoing it is my opinion that it is generally improper and misleading for an accountant to permit his name to be used in connection with any period covered by a summary earnings table or to undertake to express his professional opinion as to the fairness of the representations made for such period in a summary earnings table unless he has made an examination for such period in accordance with generally accepted auditing standards applicable in the circumstances. When the independent accountant has been the auditor for the company throughout the entire period covered by the summary, and his several examinations conformed to generally accepted auditing standards, he would ordinarily need to make only such additional review as would be necessary to satisfy himself as to whether any recasting of the statements originally prepared would be necessary to reflect transactions and adjustments recorded in later years but clearly applicable to prior operations. If the instant work represents the first engagement of the accountant by the registrant and he is to express his expert opinion with respect to the earlier periods contained in the summary, it would, in my opinion, be necessary for him to apply to the operations and transactions of each of the earlier periods with respect to which he is to express an opinion substantially the same auditing procedures as those employed with respect to the first two years of the three-year certified profit and loss or income statement included in the registration statement.[11]

"In cases where the accountant has performed sufficient work to make it appropriate for him to permit the use of his name in connection with a summary earnings table there remains to be considered the form in which he should indicate his opinion. Under the rules promulgated by this Commission, the customary method used by accountants in expressing their expert opinion takes the form of a certificate conforming to the requirements of Rule 2-02 of Regulation S-X. Such certificates make appropriate representations as to the work done, state the opinion of the accountants as to the fairness of the statements presented, and describe clearly any exceptions which the accountants may wish to take. Since, as pointed out earlier, summary earnings tables are a species of income statement it would appear that the accountant's certificate thereon should assume a comparable form, and should be included with the summary or made a part of his report as to the three-year certified statement.[12] If exceptions have been taken by the accountant with respect to any of the information contained in the summary earnings table, special care should be exercised in selecting the language used to introduce the summary to indicate clearly that such exceptions exist and to direct attention to the opinion of the accountant."

[10] Cf. Regulation S-X, Rule 2-02 (b).

[11] It is recognized that some auditing procedures commonly applicable in the examination of financial statements for the latest year for which a certified profit and loss statement is filed, such as the independent confirmation of accounts receivable or the observation of inventory-taking, are either impracticable or impossible to perform with respect to the financial statements of the earlier years and, hence, would not be considered applicable in the circumstances.

[12] Where the accounts for all the periods covered by a summary earnings table have not been examined by the same accountant, the certificate of each accountant whose name is used in connection with the table should be included in the registration statement for such part of the table as he has examined.

BOOK REVIEWS

Standard Costs for Manufacturing,

By Stanley B. Henrici. McGraw-Hill Book Company, New York, 1947. IX+289 pages, $3.50.

Those who have followed developments over the years in the field of standard costs must be impressed by the fact that standard costs are very much sounder generally than what has been written about them. In view of this fact, Mr. Henrici's text book is a welcome addition to the literature on the subject because it is a simple and clear-cut presentation which should lead to an adequate understanding on the part of anyone who is willing to follow through.

In his preface the author sets forth his objectives. Standard costs are to be explained from the "ground up." A knowledge of historical costs is assumed and no time is to be wasted, at this late date, in arguing about the merits of standard costs. The basic purposes are to describe how standards are set, how a standard cost system is installed, and how the system is operated both as a matter of accounting entry and managerial control. A careful study of the nineteen chapters which follow indicates that the author has achieved his purpose in a simple, straightforward and teachable presentation.

Beginning with the basic philosophy of standard costs, the author takes up, in order, the setting up of the accounts, the setting of various kinds of standards, the accounting for operations with the use of standards, the development and analysis of the variances, and the correlation of budget and standard costs. The concluding chapters deal with the place of standards in the development and use of supervisor's incentive plans with illustrations of the workings of that combination.

From the standpoint of teaching, the book should be a pleasure to teacher and student alike. The teacher can unfold the subject matter clearly and logically, without undue complexity, while the student should be able to grasp the development readily and come to a workable knowledge of standard costs. Each chapter is followed by a series of questions and problems. Some of the questions can be answered directly from the text. Others require reasoning on the part of the student; for this feature the author is entitled to special commendation. If any criticism is to be made, it should be that the problems seem hardly adequate for the rank and file of students. In addition, it does not appear whether a manual of solutions is available for teachers.

The book is recommended highly as a basis for a sound one-semester course in a curriculum where it can be preceded by a semester of historical cost accounting.

James L. Dohr
Columbia University,
New York, N. Y.

Cost Accounting, (a combination and revision of Elementary Cost Accounting, 1927, and Advanced Cost Accounting, 1939),

By Charles F. Schlatter. John Wiley and Sons, Inc., New York, 1947. vii + 699 pages, $6.00.

In combining and extensively revising his two former offerings in cost accounting the author has shown a full appreciation of the modern trend of texts on the subject. The reasons given for his effort are his enjoyment of the doing and, as he too modestly puts it, his hope that he perhaps had something of value to contribute.

The author has attained his stated objectives of presenting the principles of managerial control of costs as being the primary purpose of procedures, and of emphasizing principles more than procedures. Although individualistic in style, the text coverage is broad, ortho-

dox, clearly written, well illustrated, and adequate for students on the college level who are grounded in principles of general accounting. Problem material is sufficient and flexible to the extent that some problems are long, others short, and varying in complexity. Material added to that presented in the earlier texts includes treatment of purchase discounts, pricing of materials for consumption, social-security taxes, premium wages, payrolls, cost reports, basic standards, and current standard costs.

Deserving of special commendation is the clear and ingenious presentation in Chapter XVIII of text and graphic material on the effect of volume on costs and profits.

The teacher who uses the text for the first time would be wise to plan carefully his assignments. In general, many of the 23 chapter subdivisions are long, (averaging about thirty pages including problems) and from the student's viewpoint some are more difficult than others. Also there is the inevitable problem of terminology which, as usual, forced the author to select from alternatives. Strict adherence to the author's terminology is essential to maintaining students' confidence in the instructor.

HOWELL A. INGHRAM
Associate Professor of Accounting
Columbia University, New York

The Handbook of Basic Economic Statistics,

Revised Edition, GOVERNMENT STATISTICS BUREAU OF WASHINGTON, D. C., June 1947. 234 pages, $5.75, single issue.

In this one compact, up-to-the-minute *Handbook* are to be found statistical and economic data covering an astonishingly wide range both in subject matter and point of time. The tables not only go back as far as 1913, or to the earliest available year thereafter, but also contain monthly or quarterly figures for 1944, 1945 and 1946. More than that—figures are given for the months of the current year through May, 1947, in most cases, with space left to fill in the figures for the remaining months of this year. The data needed to keep this book up to date throughout the remainder of 1947 is available in the *Monthly Supplement* to the *Handbook,* issued by the same publishers, coded for rapid and convenient use in revising and extending the *Handbook.*

More than a thousand basic statistical series, covering the major aspects of the national economy, are to be found in this *Handbook,* which includes a comprehensive subject index. The tabulations of these series show the source of the data in each case, and are accompanied by helpful explanations to assure their proper understanding and use.

In the foreword to the *Handbook* it is stated that the Government Statistics Bureau is staffed with former Government economists and statisticians, its Director having served as Chief of the Economic Information and Analysis Branch of the Office of Price Administration and as Editor of the *OPA Handbook,* of which the present work is the private counterpart. The data therein, while compiled from Government sources available to all, can not be found assembled anywhere else in such convenient form.

The data and statistics are grouped in eight Parts: *National Product and National Income; Employment and Earnings of Labor; Production, Labor Productivity and Labor Cost; Profits and Working Capital; Prices, General Business Indicators; Special Security Operations; and Federal Financial Operations.* All those who have occasion to make use of such data, whether for the study of past conditions or as a basis for forecasting the trend of future events, will find this *Handbook* a great convenience and time-saver. Its value in connection with excess profits tax relief claims is obvious to anyone who has to deal with such matters.

PAUL D. SEGHERS
New York, N. Y.

ce
n-
ta
ate
is
ent
me
on-
ng

cal
of
nd
a
ou-
rce
om-
as-
and

it
tics
ern-
its
the
ysis
hin-
PA
ork
lata
ern-
not
in

aped
and
and
abor
ofits
neral
urity
ncial
occa-
ether
as a
nture
great
value
tax
who

ERS

208

19